S. Hrg. 103–692

BANKING INDUSTRY REGULATORY CONSOLIDATION

RINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

THE NEED FOR MAJOR CONSOLIDATION AND OVERHAUL OF THE BANK REGULATORY AGENCIES INTO A NEW AND INDEPENDENT BANKING STRUCTURE

MARCH 1, 2, 3, 4, AND 9, 1994

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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BANKING INDUSTRY REGULATORY CONSOLIDATION

TUESDAY, MARCH 1, 1994

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met in room SD–538, of the Dirksen Senate Office Building at 10:08 a.m., Senator Donald W. Riegle, Jr. (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The Committee will come to order.

Let me welcome all those in attendance this morning. I want to especially welcome back before the Committee, Secretary of the Treasury Lloyd Bentsen, a former colleague. I want to start out by commending you for your important leadership on this effort to consolidate the bank regulatory agencies into a new and independent banking structure.

Senator D'Amato joined me in introducing legislation on this subject last year on November 8, 1993, and we look forward to both the Administration and the Federal Reserve working with us on a bipartisan Committee Print which we plan to mark up shortly after this week's hearing schedule.

Last September, the Committee held hearings on the need for regulatory consolidation. At that time, we heard testimony from a bipartisan panel of former regulators that included, among others: Republicans William Seidman, former chairman of the FDIC; Tim Ryan, former director of the Office of Thrift Supervision; and Richard Breeden, former chairman of the Securities and Exchange Commission, as well as John Hyman, former Comptroller of the Currency.

Each of those former regulators on that hearing panel testified that a consolidated bank regulatory system would be much preferable to our existing tangled web of bank regulatory agencies.

Now some people would like to make major consolidation of our bank regulatory system a partisan issue, and others would argue that it's just not necessary. These arguments are simply not valid.

Virtually every independent study of our bank regulatory system since 1949, has recognized the need for major consolidation and overhaul.

Listen to this record. Consolidation has been advocated by, among others, the Hoover Commission, the Grace Commission, the Hunt Commission, the Fine Study, the Task Group on Regulation of Financial Services, the National Commission on Financial Insti-

tution Reform, Recovery, and Enforcement, the Bush Administration, and the list goes on and on.

The consolidation bill that I have introduced with Senator D'Amato would serve many vital interests. But the banking industry consolidation holds the promise of reduced costs of regulatory burden, including an end to duplicative examinations and often conflicting regulations.

For the general public, regulatory consolidation means a more straightforward, clearcut, accountable, and responsive bank regulatory system. For the American economy, regulatory consolidation means a more vital and competitive banking system, and that is important as well.

A more streamlined, efficient regulatory system will allow America's banks to put more effort into their core business activities and less into coping with a multiplicity of regulators.

Here is what just a couple of our former regulators said at a recent hearing in support of regulatory consolidation. This is what Bill Seidman had to say, who served for many years, I think every effectively, as Chairman of the FDIC. I quote him:

> The financial institutions regulatory system is complex, inefficient, outmoded, and archaic. It needs to be reformed with a single, independent Federal regulator.

He then went on to say:

> Do not bother to ask the regulators about it. Their turf is their only message.

That was his quote.

Tim Ryan, former director of the Office of Thrift Supervision, said to us and I quote him:

> There is only one word to describe all this. The word is gridlock. No one creating a regulatory system today would design such a mechanism.

He later said, and I quote him again:

> Consolidation makes sense and could easily be implemented over a 2-year period. Now it's time to just do it.

Richard Breeden, former chairman of the Securities and Exchange Commission during the Bush Administration, said as follows, and I quote him:

> Today's bank regulatory system is so costly, that it is creating a major threat to the competitiveness of commercial banks, and thereby undercutting to some degree the objectives the system is designed to achieve.

This is what John Hyman, former Comptroller of the Currency, said, and I quote John:

> The system we have today is archaic, expensive, duplicative, and inefficient. The costs are unnecessarily burdensome. Directly and indirectly, they are borne by the consumer and the shareholder. They can be meaningfully reduced without harmful consequences. In fact, I would argue that consolidation would improve the system of banking supervision at less cost.

In fact, I know of no independent commentator who believes that our current system is acceptable and not in need of significant overhaul. The current system is clearly characterized by regulatory overlap among the four Federal banking agencies and by redundancy of administrative authority under Federal banking laws. This overlap results in duplicative examinations, duplicative expertise, duplicative applications. The same is true with the pile-up of duplication in foreign branch regulation and in supervision of U.S. branches and agencies of foreign banks.

Of 26 major Federal banking laws, more than 80 percent are administered by either two, three, or four of the Federal bank regu-

lators. This is expensive, confusing, time-consuming, and unnecessary. It is an example of self-perpetuating bureaucracies whose basic instinct is self-preservation and it's time to deal with it.

At the same time, with no discernible accountability amongst the four regulators, there appears to be too much opportunity for confusion and therefore, the possibility of major issues slipping through the cracks because no one has clear responsibility, or else we end up with endless quibbling between the competing regulatory bodies, and we've seen that too many times.

I pose this question to my colleagues here in the Committee and beyond. Key example—which of the four banking agencies has responsibility for overseeing the derivatives market? And let me repeat the question.

Which of the four competing bank regulatory agencies has responsibility for overseeing the derivatives market? The fact that there's no clear answer to that question, I think, is a very powerful illustration of the nature of the problem that we face here and the inherent risks in continuing with the status quo.

Major consolidation is long overdue and, as a result, it is a top priority of this Committee and of mine in this Congress.

I want to wrap up by saying, again, Secretary Bentsen, how much I appreciate your leadership on this issue. The easiest thing in the world is to do nothing, to take all these sprawling bureaucracies that have grown up over time, and all this conflict, and not confront it in any fashion.

You've elected to tackle it head-on. That's one of the reasons you took the job and I appreciate that leadership. I want to say that I look forward to continuing to work with you, Senator D'Amato, and other Members of this Committee on a Committee Print that we can mark up shortly after these hearings are completed.

I believe that the Treasury Department and the Federal Reserve should be able to bridge their key differences and I also believe that I, Senator D'Amato, and other Members of the Committee can work with you to put forward a bipartisan bill which the Committee can support. It is my intention to do just that and to do it as quickly as I can.

So, with that, let me call on my other colleagues. Senator D'Amato has arrived. Let me go first to Senator D'Amato.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Thank you very much, Mr. Chairman.

I have a statement on consolidation. I'm going to ask that it be submitted for the record as if read in its entirety.

The CHAIRMAN. Without objection, so ordered.

Senator D'AMATO. The goal of reducing, eliminating duplicative examinations and wasteful practices so that we can do away with unnecessary expense is one that I think that all of us share.

Having said that, I would hope, given the various competing interests, that we will be able to come to a compromise that absolutely ensures the independence of the Federal regulators while attempting to eliminate the need for some of the duplicative efforts. I look forward to working together with you, Mr. Chairman.

The CHAIRMAN. Let me just say before you move on, I appreciate that. We've worked together on this, in putting this proposal for-

ward in the first place. I think, as we have done on interstate banking, that by working together on this on a bipartisan basis with the Treasury Department and the other participants, we can find a package that's going to work here.

Secretary BENTSEN. Mr. Chairman, I certainly share that objective.

The CHAIRMAN. Thank you.

Senator D'AMATO. Mr. Chairman, last Thursday, the Deputy Secretary of the Treasury, Roger Altman, testified at this Committee, in this room, about a meeting with top White House officials regarding the RTC's investigation into Madison. The participants reads like a "who's who" of the Clinton Administration: White House Counsel, Bernard Nussbaum; Deputy Chief of Staff, Harold Ickes; Hillary Clinton's Chief of Staff, Margaret Williams; the Deputy Secretary of the Treasury, Roger Altman; and the General Counsel, Jean Hanson.

The story from the White House is that the meeting was solely, and I quote: "Heads up about the RTC investigatory process," and suggested that it was along the lines of what was made available to Congress and the press. This flies in the face of common sense and I believe that the current story is a fairy tale version of what actually happened.

The White House Press Secretary, Dee Dee Myers, claims that the meeting was, and I quote: "Strictly a procedural briefing," and suggested that it was along the lines of what was made available to Congress and the press.

I believe, Mr. Chairman, as do others that I've consulted, that this meeting was improper, that it underminded the public confidence in the fairness and impartiality of any RTC investigation concerning this matter, that Mr. Altman should have known better than to initiate such a meeting, if, indeed, he did, and that the Treasury General Counsel should have recognized the impropriety of such a meeting.

Now, Mr. Chairman—can I have that letter?—all Congress received was a two-paragraph letter, at least all this Committee received was a two-paragraph letter that I regard as the bureaucratic equivalent of tarot cards. And to claim that the RTC gave us a similar heads-up is absolutely untruthful on its face and ridiculous.

This is what we got. By the way, I say that we got it only because the Chairman, you and your staff, interceded after we sent two letters, starting January 11th and January 25th, and it was only through your good offices that we got response to this. So this nonsense about, well, we want to give them a heads-up and it's similar to what we gave to the Congress, then they go on and they say, the same holds true for the press.

I don't know. I'd say to the members of the press, did you get a briefing? Did you get called in? Did the General Counsel of the Treasury, did Mr. Altman brief you? Was Mr. Nussbaum there with you? Was Harold Ickes, the political operative, there? Was Maggie Williams there? Maybe. We didn't get it. As far as I know, no one received this top-level briefing on the RTC's investigation weeks ago.

The charges that oversight by Congress will automatically jeopardize the efforts of the RTC or the Special Counsel is nonsense be-

cause it was only through the oversight hearing last week that this Committee learned of the possible impairment or threat to the integrity of the RTC's investigatory role, and that was as a result of interference by the White House and insiders and top Treasury officials.

So the source of this jeopardy is not congressional inquiry. It's high-level, off-the-record, so-called heads-up meetings between top political appointees running supposedly independent agencies and White House legal and political experts.

The bottom line is the American people and the Congress must know the who's, the why's, and the wherefore's of this behind-the-scene White House gathering.

In light of last week's revelations, the Senate Banking Committee, I believe, has a duty and obligation to convene a fact-finding hearing in order to learn the details of this White House meeting. And there are some obvious questions that come to mind. We've got to get the answer to these. Why did the White House counsel, Mr. Nussbaum, need to be briefed on the RTC's investigation of Madison? This investigation does not touch upon the President in his official capacity. Is Mr. Nussbaum operating well beyond the scope of his official authority? I believe that that is the case.

The President and Mrs. Clinton have outside counsel. If any briefings by any parties to this would be appropriate, and they might be, under certain circumstances, certainly not by the head of the agency, but by staff lawyers to other lawyers, it would be proper for them to meet with Williams & Connolly or David Kendall, but not operatives in the White House. They are the counsel who represent the Clintons.

What about Mr. Ickes and Ms. Williams? There's absolutely no reason that these political operatives needed to be briefed by a top agency official on an investigation. What does this investigation have to do with the Executive Office of the President?

The answer may be that one of Mr. Ickes' primary responsibilities is Whitewater damage control. And according to the Washington Post, on February 26, 1994, Ms. Williams, a former Democratic National Committee operative, had earlier joined Mr. Nussbaum in searching Vince Foster's office. Now why did they need a heads-up? Maybe to cover up, but not to help with an investigation. Why was Mr. Altman accompanied by the General Counsel of the Treasury, when the meeting dealt with subjects within the RTC's authority?

There are some other questions. Was the RTC's General Counsel advised of this meeting? Was the RTC's General Counsel asked to attend? Did the RTC General Counsel refuse to attend? Was the RTC General Counsel or any other RTC staff required to brief the meeting participants prior to the meeting? Did anyone brief the participants in preparation for the meeting? Were any documents used to prepare for this meeting? Who was involved in setting up this meeting? Are there any letters, memos, or phone logs that substantiate this? What was the exact date of the meeting? I think that's rather important. What time did it take place? Who decided who the participants would be? How long did the meeting last? Were notes taken? Was the meeting recorded or transcribed? Were any memos prepared summarizing the meeting? Who did the participants subsequently discuss this meeting with? Why hadn't Mr.

Altman recused himself earlier to avoid such potentially compromising situations? What was the nature of the conversations or comments made at the meeting? Were there any discussions of holding subsequent meetings?

Mr. Altman testified, and I quote: "It's not uncommon for meetings of that type to take place." And so I have to ask, have any other briefings of this nature on Whitewater Madison taken place, or any other RTC investigations? If it's not uncommon, I'd like to know.

The Constitution vests Congress with oversight powers. I believe we have a duty to exercise these powers, even if it may mean subpoenaing documents and placing witnesses under oath. The Congress must make sure that the independent agencies are free to enforce the law without any inside interference.

And so, Mr. Chairman, I will, in a more formal way, be presenting to you a request by Members of this Committee to convene such a hearing, the purposes for which I have outlined.

I thank the Chair.

The CHAIRMAN. Let me just say, Senator D'Amato, you and I were here through the entirety of the hearing that we had last week where you make reference to when Mr. Altman was here and was cross-examined by you, myself, and other Members of the Committee.

I think at that time—in fact, I checked the Committee record earlier today—we stayed in session until 2:30 p.m. that afternoon to make sure that everybody was accommodated in terms of the time that they wanted to take to ask questions. Having said that, I understand why you have some follow-up questions that you want to pose.

I think what we ought to do at this point, since the Committee record is still open, any questions that you have along those lines that you may have since thought about, you can certainly send over, and they could be responded to. We'll put them in the record.

I want to reserve any other judgment in terms of what may or may not be appropriate.

But I do think that questions that you may have that follow up on questions that you posed then can be submitted to the witnesses. I want to suggest to you what, I think, would be a proper option that's open to you at this point.

I also think it's important to note—I have not spoken directly to Mr. Altman, but in just following the news comments that have been made since that hearing, it's my understanding that he's acknowledged that there could be the appearance of a conflict and so he has recused himself and he, as I understand it, feels, in hindsight, that there should not have been the meeting you're referring to.

But with respect to the substance of this issue, which we talked about at great length last week, and the charter of the special independent counsel, Mr. Fisk, who is charged now and has the full legal authority of our Government as well as full investigative resources with 25 FBI agents, as I understand it, and who is actively at work investigating this issue, looking at questions that you have raised and others have raised, I think the focus of effort that properly should be there, is there.

We've got a credible independent counsel working on this. You made those comments yourself. Certainly, that's my observation.

But I think that's the way in which to deal with the remaining questions that you may have with respect to this subject. I think you ought to pursue it in the fashion that I've suggested and then we can talk about it from there.

Senator D'AMATO. OK.

The CHAIRMAN. Senator Bond.

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you very much, Mr. Chairman.

And, in answer to your question about who regulates derivatives, I'm delighted to see my friend from Connecticut here because a couple of years ago, we launched a quixotic effort to provide the SEC the power to regulate derivatives. It was a strong bipartisan effort. Unfortunately, a bipartisan group on this Committee was successful in getting 65 votes and we only got 35 votes. So Senator Dodd and I think the question is still open, but we were not real successful the last time around.

Mr. Secretary, we're pleased to see you here again so soon. We do wish it were under better circumstances.

I am not a big fan of your plan to create one superboard to regulate our banking system. I understand you made some changes in the proposal. I haven't had a chance to review the proposal, but I do see also that the Federal Reserve still has strong objections to a single regulator.

I feel that preservation of the dual banking system is important and I am afraid that a single regulator would destroy it. There are two basic issues here, and first is the elimination of the dual banking system. But what has happened recently raises another question and that is the power consolidation and potential for politicizing our bank regulatory structure.

We've discussed the first point on the dual banking system and eliminating regulation. We intend to work with you on it because, clearly, there is too much overlap and there is too much confusion.

But, as I have had an opportunity to see what's going on in this Administration, the other issue of politicizing the bank regulatory structure becomes a much greater one for me.

We already have an FDIC nominee who is certified as a friend of the First Family. We have a Comptroller of the Currency who is a friend of the President. We have the Deputy Secretary of the Treasury who is acting head of the RTC, who is also a friend of the President. The only financial regulator who doesn't have strong political connections to the First Family is the Federal Reserve. It may just be coincidentally that they are the agency who is to have most of the supervisory and regulatory power stripped away by the regulation.

You may recall in that lengthy hearing last week, there were many questions addressed to Mr. Altman. I asked him if there were special measures taken in the resolution of a failed thrift, when you find it would be affiliated with a high-profile individual like someone in Government. Mr. Altman assured me:

> The procedures, Senator, which the RTC follows are intended to be identical in each case, and they certainly have been identical in the case discussed this morning.

Unfortunately, as Senator D'Amato has pointed out, it was only a few minutes later that he had personally briefed the White House on the status of the case, after the Special Counsel had been established.

I hope, following on Senator D'Amato's discussion, that we all remember that two of the individuals who were allegedly responsible for removing Whitewater Madison files from the White House and concealing from the authorities that they had done so were ones briefed by the acting head of the RTC.

That means the acting head not only calls to ask if he can come to brief the White House staff on the Madison case, but then goes to see the very people who tried to conceal potential evidence from the investigators. The signal it raises with me is that it may be more important to uphold the bonds of friendship than to pursue the law.

In all of these cases, the clear pattern is developing that Presidential appointees somehow see conflicts of interest in their decisionmaking roles, only after they have been caught in the act. To me, that is a very real concern about consolidating power and regulatory authority in one new agency subjected to the control by the appointment of the President.

The CHAIRMAN. Thank you, Senator Bond.

Senator Bryan.

OPENING STATEMENT OF SENATOR RICHARD H. BRYAN

Senator BRYAN. Thank you very much, Mr. Chairman. I welcome the Secretary and Mr. Newman to our hearing today. I hope that we'll have an opportunity to hear from them in terms of the regulatory changes that they are proposing.

I'd like to just say at the outset that I want to congratulate the Secretary and Mr. Newman for their leadership and providing at least a point of reference for us to begin this regulatory consolidation.

As both Mr. Newman and the Secretary are aware, in Nevada, we had a situation which affected us in a more pronounced fashion than any other part of the country. And that is, we had a credit crunch in recent years in which the amount of commercial lending available in our State declined precipitously, nearly twice as much as the next most affected State.

One of the exacerbating factors was the nature of the duplicative regulatory process in which one set of Federal examiners would come in and say, you're doing precisely the right thing. Continue on. And within a few months later, another set of examiners would come in and say, wait a minute. You're going in the wrong direction. You've got to change course here.

Clearly, there was a conflicting message that, in my view, exacerbated the problems that we had in Nevada, which is rapidly expanding. My hometown of Las Vegas is experiencing the greatest metropolitan rate of growth of any community in America. Nearly 300,000 people have moved into Southern Nevada in the last 6 years. Clearly, they're going to need the capital in which to provide the business service and to provide the continued economic opportunities.

I'd like to further make the comment, Mr. Chairman, if I may, that I also appreciate what the Secretary and Mr. Newman have done with respect to dealing with the problem that's a constant refrain, not only with respect to the regulatory issue that we discuss today, but the paperwork burden, the redundancy.

You have worked very effectively in addressing some of the problems that deal with the currency transaction reports that have been particularly burdensome, and I just want to acknowledge and say publicly, I appreciate your leadership. I think you're on the right track. And I look forward to working with you and your colleagues at Treasury, Mr. Secretary.

The CHAIRMAN. Senator Mack.

OPENING STATEMENT OF SENATOR CONNIE MACK

Senator MACK. Thank you, Mr. Chairman, and welcome, Mr. Secretary.

While I share some of the goals that you have indicated with respect to the establishment of one regulatory authority, I must say that I am concerned about some of the potential problems that would develop, the first of which is the concentration of power, and not so much from the political perspective that has been raised this morning, but I raised these points back during the so-called credit-crunch, during the recessionary period, when many people around my State, and I think not just in Florida, but frankly, throughout the country, were raising concerns about what was happening as far as lending was concerned. They were making comments with respect to how certain regulators were harder on real estate loans, commercial real estate loans, and so forth.

All of that, to me, and again, I relate that to a concern that I've raised with the concentration of power with respect to branching throughout our Nation.

In my State, roughly four financial institutions control about 75 percent of the deposits. I wonder about those four individuals getting up one morning and deciding, well, we're just not going to lend in a particular area or on a particular type of loan. It's a tremendous amount of power. It can have significant economic impact within the State and within the Nation.

I'm concerned about one regulatory agency having the ability to have such significant effect on the lending practices of our financial institutions, number one.

And second, I am concerned about the removal of the Federal Reserve from what, I think, is a very important opportunity and responsibility in operating monetary policy. I know this is a point you disagree with and that you and Alan Greenspan have had discussions about.

But I would make the case that, in order to make the kinds of decisions that are important during times of monetary crisis, let's say, that the Federal Reserve needs more than reading an examination report, that having their people in those institutions would be very helpful in trying to make decisions relative to what they should be doing to meet a particular crisis.

While we share many of the same objectives, and I'm looking forward to working with you and trying to find a way to accommodate

what is being proposed, I have those reservations and others. I wanted to express those this morning.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Mack.

Senator Dodd.

OPENING STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you very much, Mr. Chairman. Let me ask unanimous consent to have a prepared statement put in the record at this time.

The CHAIRMAN. Without objection, so ordered.

Senator DODD. And to welcome our former colleague and the Secretary. And to make two points.

One, regarding this particular issue before us, which is a very important matter—I commend the Chairman for the work he's done. We're going to have some extensive hearings.

My own view is that the status quo is unacceptable with regard to the present scheme of regulators. There's no argument that I know of that states we could sustain the present system given its inefficiencies and the problems associated with it.

Having said that, and I've expressed this view to the Chairman and to the Secretary very, very briefly, I'm concerned about reaching a bit too far with regard to the Fed. I'm going to wait and have a chance to talk with the Secretary. He and I have talked about this already.

My hope is that there might be some room to strike a balance before this process is through, and I'm confident that may be the case.

But, nonetheless, I think it's important that we begin with what has been presented to us here. I think it's absolutely the correct and proper direction for us to be going in. Whatever modifications we may make, certain arguments can be raised.

I think, clearly, to do nothing would be inexcusable, given the problems we've seen unfolding in the last several years. So I would make that particular point.

Last, I want to say to you, Mr. Chairman, that I think you're on the right track with this other matter. My colleague from New York and I are close friends. We've worked together. In fact, he and I led the charge, if you will, on the statute of limitations issue a couple of years ago.

I have a great deal of confidence in Robert Fisk. He's been on the job a little more than a month. He's a highly competent, extremely talented individual who is going to look at all aspects of this matter. He has a sweeping mandate and his goals are very unambiguous.

I think it's important for us to allow that job to be done. We've seen in the past the problems where congressional investigations can complicate the work of independent prosecutors. I think we'd be well advised, in this body, to listen to those admonitions and concerns and to allow this process to go forward in the hands that it presently is in; specifically, former judge Robert Fisk.

I'm appreciative, Mr. Chairman, of your particular position on this. I think you're on the right track.

I would ask the Secretary, Mr. Secretary, if you might comment on the possibility of some middle ground being struck with regard to the proposed consolidation approach, and whether or not you think there's any value in limiting or defining the role of the Fed in terms of the international lending institutions as a way of preserving their unique role, or whether that is just a nonstart, as far as you're concerned.

The CHAIRMAN. Do you mind if we have him do that in that normal course of his statement?

Senator DODD. Yes. Fine.

The CHAIRMAN. Senator Bennett.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

I agree with Senator Dodd that the status quo was unacceptable. I think that we need some consolidation. I think that's very clear. I commend the Administration and the Chairman for pursuing that matter.

I also agree that the implication that the proposal before us may go too far and we need to be very careful before we automatically accept it just because we're looking for some kind of change.

While I look forward to hearing the Secretary's testimony, I also, before making up my mind on this, want to hear from the regulated.

We're hearing anecdotes about banks in California, where there are more regulators than there are customers. I think they're undoubtedly accurate. But I've been surprised that the regulated have been very silent, as far as I'm concerned, on this issue. They've not been to see me with the same kind of firepower that both the Administration and the Fed have used.

Senator MACK. They will now.

Senator BENNETT. They will now.

[Laughter.]

I had Mr. Newman in my office, and that was very enlightening. I had Mr. Greenspan in my office, and that was very enlightening.

The CHAIRMAN. We'll have the regulators in here tomorrow and hopefully, that will be enlightening.

Senator BENNETT. Yes, and then you'll have the regulated. So before we rush to act on this one, I would hope that we would hear from those who are raising the complaint about duplication of regulation as to the suggestions they might have.

I would think we might get a different picture from them as to the benefits of consolidation than we're getting from those who see not only the benefits in the marketplace, but, being blunt about it, see the benefits in the political marketplace in terms of expanding their own turf.

Now, I would never accuse Secretary Bentsen of being concerned about turf, but there are some brownies in his department that may have that predilection somewhere.

The other comment that I would make to the Secretary, I have another hearing going on that I'm going to have to leave for, so that I may not be able to get back to hear all of his testimony. Consequently, I read ahead and have gone through his summary testimony.

I would suggest to you, Mr. Secretary, that you don't put too much reliance on this chart to make your case. I've read the chart and there may be something wrong with me, but I find it quite clear. I find it quite helpful. While the first glance at it says, my gosh, this is an incredible interlay, overlapping mess of regulation, when I read it carefully, I find, for example, that under consumer protection rulemaking, every column is the same. It says the Federal Reserve. That's consolidation rather than confusion.

I take an institution, the credit unions, for example, and say, boy, they should be worried about this, and I find footnotes all over the place. I read the footnote and it says, Federal credit unions are not required to receive NCUA approval before opening a branch.

So the footnote says, they shouldn't be on the chart in that regard. You begin to trace some of these across and trace some of these down, and you find that it's not nearly as confusing as the first glance at the chart might lead you to believe. Indeed, as I got into the chart, after Mr. Newman left me a copy of it, I came away thinking, the prima facie case out of the chart is that the thing seems to have been sorted out fairly well.

I would just suggest to you that you not put a whole lot of reliance on it because, as I read the fine print and read the footnotes, it doesn't make the prima facie case that there's too much overlapping regulation. Instead, it just leads somebody through the maze of regulation in such a way as to cause somebody to say, well, now I understand it and now I can comply.

Now, having said that, I go back to my opening comment. Yes, I agree that the status quo is unacceptable and that we do need some changes. But, like the Senators who preceded me, I'll be very anxious to be very careful about what those changes are instead of embracing, wholesale, a proposal just because we need some kind of progress.

Thank you.

The CHAIRMAN. Thank you. I think when we hear from Mr. Newman, he can perhaps shed a little light on that chart as well.

Senator Roth, a comment before we go to the Secretary?

OPENING COMMENT OF SENATOR WILLIAM V. ROTH, JR.

Senator ROTH. Well, thank you, Mr. Chairman. I appreciate the fact that you and Senator D'Amato have agreed to hold these hearings. It's always a pleasure to welcome our former colleague and good friend, Secretary Bentsen.

Secretary BENTSEN. Could I just interrupt? I see Senator Bennett is—could I just make a comment to him, if I may?

The CHAIRMAN. Sure.

Secretary BENTSEN. Senator Bennett, let me make a comment to you on this question of turf.

At the present time, Treasury has the supervisory responsibility for 62 percent of the assets of the thrifts and the banks.

We're giving that up. I must tell you, as Chairman of the Finance Committee, I had no reputation for giving up turf. I fought for jurisdiction.

But, in this situation, I feel so strongly about the consolidation and what can be done for a more effective organization, that we're

giving it up, 62 percent of what we now have in the way of the assets of thrifts and banks that we supervise.

Senator BENNETT. Thank you, Mr. Secretary. Help me understand.

Wouldn't this consolidated agency be more responsive to direct Presidential appointees who change with the President, rather than the independent agencies?

Secretary BENTSEN. Appointments to independent agencies are made by the President. The FBC will be very comparable to what you would have with any other independent agency.

Senator BENNETT. Excuse me. I'm sorry. I was distracted.

Secretary BENTSEN. I said you have the appointments being made by the President at the present time. It will be an independent agency. The President could remove one of the three appointed members only for cause.

I think our proposal will significantly reduce any bank regulatory politicization. The OCC and the OTS are currently bureaus of the Treasury, and as I said, now handle 62 percent of those assets. We will cease to be a bank regulator in exchange for one seat on the Commission, one seat only.

Senator BENNETT. I appreciate that clarification. I reserve the right to still look into the political implications of what the overall Commission would be in terms of turf within the Administration and the power that it might give to political appointees of the President. I appreciate the clarification you've given me, Mr. Secretary.

The CHAIRMAN. And, if I may say, it's very important to understand here that my goal is to not have this issue be politicized. On the contrary. Certainly you have some of that because of the appointment process. But we've also got the confirmation process.

We all are here essentially as a check and balance on that very issue. We've had nominees come before this Committee just in recent years that have, in fact, been turned down.

So that's certainly not automatic, nor is it when appointees get to the Senate floor. We have our turn at bat here as the Committee of jurisdiction, but then the Senate as a whole has to render judgment as well.

But I would just make one other point, and that is that I think today, banking regulation is a rather arcane area. And the more regulatory jurisdictions there are and the more separate turfs there are, the more they are under the radar. They're out there. Most people don't know who they are. They operate rather anonymously, when all is said and done.

I think the kind of consolidated commission that is being talked about here will lift the visibility and increase the accountability of the regulators. I'm not looking at it from the point of view of one Administration or one party because that changes with time.

I think what we need is a bank supervisory body that not only has the power to act, but is under the spotlight and scrutiny where I think the performance is likely to be looked at more carefully and is likely to be better executed at the end of the day.

Now that's a judgment call and I'm as sensitive as you are about making sure we do this right. I have a keen sense about the very

issue that you raise. But I think we've got that problem today and we've had that problem in the past.

I think that's one of the things that if we do this wisely, we can, in fact, correct. And that is to, in effect, remove this further from the politicization process or the possibility of that.

I think just the fact that the Treasury Department is surrendering jurisdiction to a body in which, yes, they participate, but they participate with a number of other individuals, including the Federal Reserve Board, provides the very kind of check and balance that I hear you saying you feel the need for, and I feel that same need.

In any event, we'll hear from the regulators tomorrow and they'll have a chance to give us their views.

Senator BENNETT. You say we'll hear from the regulators tomorrow. Are we going to hear from the regulated?

The CHAIRMAN. Yes, we'll hear from them as well.

Senator BENNETT. OK.

Secretary BENTSEN. Let me——

Senator BENNETT. Yes, sir.

Secretary BENTSEN. Because I value Senator Bennett's opinion as well, I want to make another point on this one.

At the present time, bank supervision is conducted by the OCC, the OTS, the FDIC, and the Fed. The members of the FDIC and Fed Boards and the heads of the OCC and the OTS are all selected by the President.

The FBC, the Federal Banking Commission, will not expand the number of politically appointed supervisors.

Senator BENNETT. I understand that. It does consolidate some power there.

I don't come here with any firm objections, other than the general unease that I do get from the concept of a single superagency in an area that, at least some people are saying, would be destructive to the dual banking system.

You address that in your testimony. You're very clear about that in your testimony. And I'm delighted that you have focused on that because I think that's an issue we have to look at and pay attention to.

I come back to my beginning position. I agree with you, the status quo is unacceptable. So I look forward to working with you and the Chairman in seeing how we can resolve some of these things and come up with something we can all agree is progress.

Secretary BENTSEN. I apologize to the other Members of the Committee for interrupting the sequence, particularly Senator Roth.

The CHAIRMAN. Thank you for yielding, Senator Roth.

Senator BENNETT. Thank you.

Senator MACK. Mr. Chairman, if I could just——

The CHAIRMAN. We've got a former banker here.

Senator MACK. No. I've said what I need to say. I'm off to another hearing and I wonder if I could submit several questions that could be responded to in writing.

The CHAIRMAN. By all means.

Senator MACK. Thank you.

The CHAIRMAN. Without objection, it is so ordered.

Senator Roth, did you want to complete your comment, and then we'll go to the Secretary.

Senator ROTH. Yes. Thank you, Mr. Chairman.

Lloyd, I want to thank you for the personal leadership you're showing in this matter, putting the issue of regulatory consolidation on the front burner.

Frankly, I know from past experience that it's practically impossible to achieve any real reform without strong leadership from the top, and there's no question in my mind that you're committed to right-sizing Government in this crucial area.

Now, while I stand behind efforts to improve the effectiveness and efficiency of Government programs, and I'm all for reducing unnecessary Government regulation and duplication, I must also say that I have some concerns when it comes to plans to create a new Federal Banking Commission.

Don't get me wrong. I agree that our Federal regulatory structure may be enhanced through consolidation, and that many banks could benefit from reduced regulation and oversight. However, I am concerned that the creation of a single Federal super-regulator could well have the opposite effect. Would a single bank regulator issue even more cumbersome requirements for banks to adhere to? And, most importantly, would the States' role in bank supervision be adversely impacted?

For example, if the Federal Banking Commission is to regulate both national and State banks, will the nonconforming powers of State banks become over time to be viewed as different and therefore bad policy?

I'm also concerned with the Commission. Under your proposal, is it not natural for the Commission to look favorably upon the banks it's created, the Federal or nationally-chartered banks, over those of other State institutions?

It's this kind of question that will concern me. But I do look forward to some right-sizing here and I applaud your initiative and look forward to working with you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Roth.

Mr. Secretary, we're very pleased to have you here today. You've already made some important comments in the exchange we just had.

We'll make your full statement a part of the record and we'd like your comments now.

STATEMENT OF LLOYD BENTSEN, SECRETARY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC; ACCOMPANIED BY FRANK N. NEWMAN, UNDER SECRETARY OF THE TREASURY

Secretary BENTSEN. Fine. Thank you, Mr. Chairman, Members of the Committee.

I've appeared before you to discuss other issues, but I think few of them are as important as bank consolidation of the Federal bank regulators.

From my experience in the Senate, I know it's a lot easier to kill a bill than to pass a bill. And I know it's going to be quite challenging for you, Members of this Committee, to resolve any concerns. However, I also realize the importance of addressing this matter

now, rather than waiting until it has to be dealt with in some kind of a financial crisis.

First, let me express appreciation to the Chairman and to Senator D'Amato, for inviting the Administration to formulate and present our proposal. I greatly appreciate that effort. I know it's the desire of all the Members of the Committee, as well as the Administration, to work together on this one.

I have a longer statement that I'd like to put into the record.

Well, here's where we are today—four different agencies regulating depository institutions—the Office of Thrift Supervision, the Office of the Comptroller of the Currency, both under Treasury, the Federal Reserve, and the FDIC.

These aren't nice, clean boxes on an organizational chart. Seventy percent of the Nation's commercial bank assets are held by organizations regulated not by one organization, but by two. And almost half are regulated by three or four.

Now, in spite of Senator Bennett's full understanding of this chart—and let me say that a U.S. Senator studying it in great detail, and with a background in legislation, may be able to figure it out——

I think the general public is not afforded the opportunity for the kind of intense, minute study of it that one would like. And I think it is confusing, in effect. In fact, I'm thinking of letting Bob Dole and Arlen Specter have this chart.

[Laughter.]

Let me say that under the—c'mon, Al. That's not bad. That's a pretty good line.

[Laughter.]

Under the Consolidation Act of 1994, we'll combine supervisory and regulatory functions of the four Federal bank regulatory agencies into a single Federal Banking Commission.

You're going to recognize a lot of our proposal because it incorporates many of the elements of bills introduced in the Congress, particularly the bill introduced by you, Mr. Chairman, and Senator D'Amato, and in the House, by Chairman Gonzalez and 12 other Members of the House Banking Committee.

Our plan also builds upon many bipartisan proposals that have emerged over the past 45 years. The first commission that called for it was the Hoover Commission. We've seen several since. We saw it in the Grace Commission under President Reagan. We saw it with President Bush.

And, like your congressional proposals, ours attacks redundancy and waste by realigning regulators according to their core functions of regulator, central bank, and deposit insurer.

The core functions of the Federal Reserve, as the central banker, and the FDIC as deposit insurer, will not be disturbed—will not be disturbed. Nothing, nothing in our proposal will affect the Federal Reserve's independence, deprive it of needed information, or hamper the performance of its essential functions.

It will continue to conduct monetary policy, administer the payment system, and provide liquidity through the discount window. These are all important components of our plan that have been misunderstood. I'll say more about that later.

Let me say something about the State-chartered banks regulated by the States. That's something else that's been misunderstood and some concern has been stated for that.

They'll continue to play their important role. The dual banking system will not be weakened by this. I used to be the chairman of the board of directors of a community bank in Texas. I also served on the board of directors of a large bank. If I thought the dual banking system would be weakened, I would not be here.

Nothing in the Act gives the Federal Government any additional authority over them. Nothing prevents an institution from seeking a State, rather than a Federal, charter. And our proposal provides the opportunity for State supervisors to take on more of the responsibilities for their banks.

To be blunt, I see critics of our proposal confusing the dual banking system with having a choice between different Federal regulators—Federal regulators.

The CHAIRMAN. Right.

Secretary BENTSEN. Our plan preserves the dual banking system, while eliminating a confusing Federal regulatory structure that, as Secretary of the Treasury, I find redundant and wasteful. What we're seeing is a situation that enables banks to shop for the most lenient Federal regulator.

As Senators, you ought to worry about a system where the more faithfully an agency implements the laws that you enact, the more likely the institution it regulates will look for a more lenient regulator. That, right there, is a key reason to consolidate.

I was before you last week talking about our worst financial crisis since World War II. One lesson we'd better have learned is that our regulatory system did not adequately anticipate or resolve the S&L crisis. In the months and the years ahead, I don't want to have to appear before you, as my predecessor did, to ask you to take costly measures to contain some other crisis. I say fix the roof while the sun's still shining. I ask that we take the actions now, while we can, so none of us will be forced to take some action with a gun to our head.

We need a Federal regulator that can focus on the banking industry full time, an agency that will keep the industry healthy, that will promote a safe and a sound system.

Over the past 20 years, the percentage of financial institution assets in banks and thrifts have shrunk. Listen to what's happened to the banking industry insofar as its percentage of total financial assets are concerned. It's gone from 62 percent to just 36 percent, and that's the lowest level in history. That's a tremendous loss.

I'll tell you who that impacts. Senator Bryan, you were making that point. It attacks small business on Main Street. That's who it gives a problem. The big fellows can get their money on Wall Street. But the small business people, the job-creators in this economy, they go to their local bank. There will be a lot of benefits from this. Let me take you through seven of them in some detail.

One, we can do a better job of regulating. Almost three-quarters of a trillion dollars in assets are in companies that control a national bank, a State nonmember bank, and a thrift. And that means they have four regulators. The Fed does the holding com-

pany. OCC, the national bank. FDIC, the nonmember bank. And OTS, the thrift. And what happens?

We have a situation where each regulator relies on the others for parts of the institution that they're not responsible for.

Incredibly, there are thousands of cases where our system has layered on separate regulators for the holding company, even though that agency regulates none of the entities that actually make the loans. None. It's fragmented. We don't get a complete picture. And we can sure do better than that.

Two, consolidation will eliminate inconsistent and duplicative regulation. Four agencies, four sets of rules, four sets of inspectors. Bankers often see different regulators apply different rules to similar situations. Sometimes they see them apply the same rules differently.

The CHAIRMAN. Mr. Secretary, if I could just stop you there.

Secretary BENTSEN. Yes.

The CHAIRMAN. I talked to one banker who had three different sets of regulators in at the same time and there wasn't even space to accommodate everybody. Just finding the physical place to put them as they were all doing different things at the same time.

Excuse me.

Secretary BENTSEN. Under our plan, there will no longer be a need to coordinate policies and regulations among different agencies. It has sometimes literally taken an act of Congress to get the agencies to coordinate.

Mr. Chairman, you led in that effort. Senator D'Amato did.

Now, three, we're going to see more accountability.

Today, when complaints arise in the industry, the various agencies can sidestep accountability. They point the fingers at the others insofar as the responsibility and the accountability. Let me illustrate.

In the mid-1980's, the warning signs were clear that banks had overinvested in commercial real estate. I can still see the see-through windows we had in commercial buildings down in Houston, Texas, for loans that were going on. But the regulators could not agree on a unified strategy to address that problem.

Under our plan, Americans who pay the regulators' salaries but can't afford banking lawyers to guide them through the regulatory maze will know where to go when they have a problem—the Federal Banking Commission. Period.

Four, it will eliminate potential conflicts when agencies perform dual roles.

Look at the Federal Reserve—as regulator and central bank. The two functions compete for the time and the energy of policymakers, and you know that bank regulation has to take a back seat to monetary policy.

I spent the weekend in Germany at the G–7 meeting of Finance Ministers and central banks. I talked in detail to the Bundesbank. Certainly, that is one of the most powerful, one of the most influential central banks in Europe. They do not have examination authority and told me they didn't want it. They didn't want to be put in that position.

Look at the FDIC. As an insurer, it has incentives to resist innovations, even if those innovations may be exactly the changes that

banks need to maintain a healthy position and be responsive to evolving customer needs.

Five, consolidation works better and costs less.

OMB says that our plan reduces Government spending between $150 and $200 million a year—15 to 20 percent of today's costs. Direct savings to the banking industry, and ultimately, the consumer, will be substantially greater than that.

I can't tell you whether the savings in the private sector will be 5 percent or 25 percent. But based on a 1992 study, chaired by Federal Reserve Board Governor, John LaWare, each 5 percent reduction in regulatory burden that this reform achieves will save the industry $1 billion.

Six, a single regulator will be responsive to the concerns of community banks.

In the present system, most small banks are regulated either by the Fed or the FDIC. And, like I said, they have other jobs, other priorities. Under our plan, small banks will have a regulator solely dedicated to responding to supervisory concerns. They'll be in all 50 States, and if they're not responsive, I'm sure they'll be hearing from Members of the Congress and from this Committee.

Seven, and finally, a consolidated agency will assess fees and expenses more equitably among institutions. We made some changes on that one that you will be interested in, I think.

Like OCC and OTS and FDIC, the Commission will not require any taxpayer funds. It will recover all its costs through nonappropriated means. The Administration's proposal incorporates a funding method for the Commission that's fair to both national and State banks and institutions of all sizes. That's not the case now.

I know a number of State-chartered community banks have worried that the Commission might impose heavy fees on them. Many of those bankers feel they're already contributing to the Federal supervision costs through a portion of their FDIC premiums, and I agree with that. And they pay fees to their State supervisors.

We've heard their concerns and we agree, they make sense. I'm happy to present a plan that calls for no fees, no fees to be paid to the new Commission by State banks for the first $1 billion in assets. That means 7,500 State-chartered banks, more than 90 percent of all State banks, will have no fees, none, assessed by the Commission. Larger State banks will pay half the rates, reflecting the role of the State supervisors.

A lot of people have endorsed this proposal, including several former regulators, including Peter Grace, including some of your former colleagues. But there have been some critics, in particular, members of the Federal Reserve. They agree consolidation is needed. But they have a different idea of how to do it.

I have great respect for the Fed and for its role in the monetary policy and financial system. This proposal not only assures that the Fed has the authority it needs, it improves the Fed's involvement in supervising major banks, but within a much more workable and efficient framework.

They have their own proposal. They think two full-scale regulators would be better than one. I'm not persuaded. Two isn't necessary. The Federal Government is not Noah's Ark. We don't have or need two Securities and Exchange Commissions, where big com-

panies can decide which one they want to deal with that might be more favorable to them. Or two Food and Drug Administrations. Or two central banks. We don't need two sets of rules and interpreters, or two sets of examinations.

It's also a mistake to believe that competition among bank agencies is needed to promote financial product innovation. Innovation is not initiated by bank regulatory agencies. It's initiated by the marketplace. That's what brings about innovation—responding to the demands of the customers. It's the nonbank financial service providers that dominate the industry, and our current unresponsive, inefficient system that's killing the banks' ability to compete with them.

Some critics argue against full consolidation on the grounds that it eliminates checks and balances. Congressional oversight of the regulators is a check and balance. So are the courts. And the State bank system. And the press. And the marketplace. And the new Commission's board. We don't need two Federal regulators to serve as a check and balance for every bank.

Nevertheless, we believe that the Fed should play a meaningful role in bank supervision. There is a legitimate concern that I know some of you expressed about very large banks, that they really warrant special attention. We've heard those concerns and we agree.

Our proposal provides a backup system between the Commission and the Fed for the top 20 banks. If either agency sees a serious problem, it can act to correct it in any of the 20 largest institutions. And those 20 make up 35 percent of total bank and thrift assets. Thirty-five percent.

You know how much the Fed supervises now? Fifteen percent. That's what their role is. It supervises 15 percent.

In addition, the Fed will be able to select each year 10 of those top 20 for joint examination. Those 10 would make up 25 percent of total system assets. And, for any of the 10 that have historically been supervised by the Fed, the Fed can take the lead role in the joint exams, but there will be just one examination per institution. Just one.

Now, today, the Fed directly supervises and examines only 7 percent of all FDIC-insured depository institutions. Only 15 percent of the Nation's bank and thrift assets, only 5 of the 20 largest institutions, and only 12 of the 52 U.S. banks with assets of more than $10 billion. For information concerning the remaining 93 percent, including most of the large organizations, the Fed relies on reports prepared by the OCC, OTS, or FDIC.

Now, some say the Fed needs bank supervisor powers to guard against systemic risks—crises that affect the financial system—like the stock market crash in October 1987. I'm a Depression kid. I understand the failure of banks. But not every disturbance is a systemic risk. And, in these times, possessing supervisory capabilities is unlikely to improve the ability of the Fed to anticipate shocks.

The financial system encompasses far more than the Fed supervises—the stock market, the bond market, commodities market, the insurance industry.

Our proposal won't affect the Fed's ability to react to a systemic shock. It will continue to regulate the payments system, and be ac-

tively involved in the supervision of the largest banks. The Fed's done just fine in the past and it will continue to do fine in the future.

The monetary policymakers at the Fed don't conduct bank exams themselves. They get information they need from examination reports, just as they will under our plan. The Fed does say that some involvement in some statistical cross-section of banking is useful to them.

Fine. Our proposal provides an opportunity for the Fed to participate in exams of just such a cross-section in a way that doesn't duplicate or overlap the Commission.

These banks all across the country could compose up to 5 percent of total system assets. Between their participation in exams of the largest banks and the cross-section, the Fed would actually be involved in banks with 30 percent of system assets, compared to 15 percent now.

So, the Fed will have better information, without all the overlapping and confusion of today's structure. And this Commission will have a board. The Fed will have a seat on it.

The Treasury will also have a seat. And there will be three others appointed by the President, confirmed by this Senate. Both parties will be represented. One member will have experience in supervising State-chartered institutions. This board will bring balance and judgment to the job of regulation.

The new Commission will have access to a range of views on policy matters. It will have advisory councils for community banks, both State and national, for thrifts, consumer issues, and small businesses.

I look around the world. I've dealt with many Finance Ministers. This trip this weekend once more buttressed it. And, as I talked to the Bundesbank, they made their points to me.

I have to tell you, no other country has a regulatory system anywhere near as confused as ours. Not one. It's a serious disadvantage in today's competitive world for our Nation to have our banks that serve our economy hobbled by our regulators.

I've heard enough stories, like the one you were telling, Mr. Chairman. Let's stop tripping over each other.

This plan provides each bank one examination, one application, and one report to their board of directors. That will leave the bankers time to make loans, instead of spending all day filing multiple regulatory reports.

The need to restructure has been around a long time. I want to read you one quote:

> The banking regulatory system is a crazy quilt of conflicting powers and jurisdictions, of overlapping authorities, and gaps in authority.

And that's from a Fed annual report of 1938.

The need has grown more urgent over the past several decades, as distinctions between depository institutions have blurred and the regulatory system has grown more costly, more complex, less efficient, and less responsible.

I talked about the advantages. You're probably thinking, what are the disadvantages? Whatever we could find, we tried to correct.

So when you make the improvements, someone is going to protest the way that it will be done. They'll resist change. We have to join together to overcome that resistance.

The OCC and the OTS are bureaus of the Treasury and, as I told you, represent 62 percent of bank and thrift assets. We are prepared to give up that authority.

In this time of economic stability, when bank profits are at an all-time high, we have a window of opportunity to take bold action to improve the system, to make it work better, cost less, to promote a safer, sounder banking system, and to promote a more efficient system.

For all those reasons, I urge this Congress and I urge this Committee, and I urge both sides of the aisle, to help us pass this legislation.

I'm here to answer your questions, Mr. Chairman.

The CHAIRMAN. Thank you. I've heard a lot of statements made by Cabinet officers and others over the 28 years that I've been here. But I must say that I think the thoroughness and the logic that you've presented here and buttressing it with the hard, cold, numerical facts, gives this presentation great weight and great meaning and I thank you for that.

I think any time we try to change anything in Government, you run into the forces of the status quo, especially if you're talking about established bureaucracies. Nobody wants to reduce their work force. In fact, everybody seems to have a desire to want to increase their work force.

I was surprised that the first reaction of the Fed to consolidation was they wanted an increase of regulatory power. They want to stretch out and take on more things.

Furthermore, I was struck by your comment that when you met with the officials of the Bundesbank, thought by many to be the premiere monetary policy body in the world, they have no bank regulatory authority themselves directly. They are not in that business.

Secretary BENTSEN. They have no examination authority.

The CHAIRMAN. Exactly. That's done by others and they seem to be able to function quite well under that system.

Let me start by asking you this question. There are two arguments that the Federal Reserve System has made. The first is that they have to have hands-on, day-to-day, bank examination authority in order to deal with systemic risk. And, second, that they have to have hands-on, day-to-day, bank examination authority in order to conduct monetary policy. How do you assess those two issues from your vantage point?

Secretary BENTSEN. Well, first, I don't agree with the Fed that they have to have a direct role in bank supervision to handle systemic crises.

I made the point that many of the financial crises have not been triggered by banks. The Fed was able to handle the 1987 stock market crash, the Penn Central Railroad bankruptcy, and the Ohio thrift crisis of the early 1980's, without a direct supervisory role in any of those industries. Then you've had the recent statutory changes enacted in the FDICIA. They further reduce the likelihood that banks will trigger a crisis.

The Fed uses discount window lending, not banking regulation, to battle systemic crises. The proposal would not affect the discount window authority.

The CHAIRMAN. Let me ask you this. It's my understanding that the cost of the two regulators that you have under the Treasury, the Comptroller of the Currency and the Office of Thrift Supervision, are fully covered by fees paid by the industries that they supervise. Is that right?

Secretary BENTSEN. That's correct.

The CHAIRMAN. So those regulated entities and those regulators don't contribute at all to the deficit because they're, in effect, self-financing. Is that correct?

Secretary BENTSEN. That's right.

The CHAIRMAN. What about the Federal Reserve fees? What kind of fees does the Federal Reserve charge?

Secretary BENTSEN. They don't charge.

The CHAIRMAN. They don't charge any fees.

Secretary BENTSEN. No.

The CHAIRMAN. It would seem to me, the fact that they don't charge any fees means that whatever they're spending on regulation and supervision, they're not recouping in a fee structure, although the other two regulators I've just cited, they do recoup their costs through their fee structure.

Secretary BENTSEN. Right.

The CHAIRMAN. So, to the extent that the Fed is involved in regulation and supervision and they don't charge any fee for it, that goes right on through to the Federal deficit, doesn't it?

Secretary BENTSEN. That's correct.

The CHAIRMAN. I'm told that even the very largest institutions, and I think this will come as a surprise to a lot of people, that the very largest institutions under Fed supervision do not pay the costs of their Federal supervision.

Secretary BENTSEN. That's correct.

The CHAIRMAN. It's my understanding even J.P. Morgan, as big an operation as it is, pays nothing for its supervision by the Fed. Is that correct?

Secretary BENTSEN. That's correct, Mr. Chairman.

The CHAIRMAN. So who's paying for that? Aren't the taxpayers paying for that?

Secretary BENTSEN. That means, in effect, that, to that extent, the Federal Reserve does not return it to the Treasury and it does not apply to a reduction of the deficit.

The CHAIRMAN. It also means that if somebody is out there regulator shopping and they decide to move out from under the OCC or the OTS, and they were to go on over to the Federal Reserve, it actually will have the effect of increasing the deficit because you've got a situation where you've got a charge, but no offsetting revenue.

Secretary BENTSEN. That's correct.

The CHAIRMAN. How does the proposal that you have before us correct that inequity?

Secretary BENTSEN. I beg your pardon?

The CHAIRMAN. I want to ask you, finally, how does the proposal that you have before us correct that inequity?

Secretary BENTSEN. For example, the vast majority of State-chartered banks and community banks would not have fees assessed by the FBC. But the large institutions would pay their fair share.

I'll give you an example as I understand it. You cited the J.P. Morgan. Take Citibank. I think that they pay a fee of approximately $9 million. That's the difference.

The CHAIRMAN. It's a good illustration. Let me just ask you one other thing and then I'll go to Senator D'Amato. And that is, some have raised what I consider to be a false fear about a risk or a threat to the dual banking system. I'm not going to report a bill out of here that contains a threat to the dual banking system because we believe in it and want to preserve it, and clearly, we will.

I think it's gorilla dust being thrown up in the air, in order to create a false concern.

In order to address the point directly, I would like a response from you on the issue of the dual banking system, and, again, your statement and your view as to why this would not injure the dual banking system, but maintain it and, in many ways, probably strengthen it.

Secretary BENTSEN. I certainly share that objective with you. The dual banking system, I think, is a very important part of our banking tradition and I think it ought to remain so.

Our proposal will not affect the dual banking system. Our proposal will not give the Federal Government any additional authority over State banks or State regulators. That information has to get out to those smaller banks. Some of them don't understand that. It has not been clear to them.

The proposal must and will preserve the 51 different testing grounds State regulators provide for new ideas. States will continue to be the primary regulators of banks that they charter. Federal regulators will continue to be able to rely on State examinations in alternate years, as under the current law.

As under current law, the FDIC will be the only Federal agency with authority to restrict the activities of State banks. The Federal Banking Commission will establish a system for certifying State banking departments and will then place increased reliance on examinations from those States. The Commission generally will not duplicate examinations of small, well-capitalized State banks conducted by certified State agencies.

Under this approach, almost 60 percent of all State banks will probably be examined only by State regulators.

The CHAIRMAN. Thank you very much, Mr. Secretary.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Secretary, I, again, along with the Chairman, have supported legislation that basically looks to deal with eliminating the duplication that is nonproductive and that does not enhance the soundness or the safety of operation of our various banks.

Having said that, there's no one in this room that doesn't understand the pushing and the tugging that's taking place so that various interests of the regulators, those interests which they consider to be absolutely paramount to the safety of the overall financial institutions that we're speaking about, will be covered.

Some may be motivated with that very sincere interest and some may be part of the natural tendency to preserve one's stake.

Having said that, let me ask you, has the Treasury attempted to work out some of the differences that have been raised with these groups, with the Fed, in particular, through any direct negotiations?

Secretary BENTSEN. Oh, yes. Secretary Newman has visited with them, talked to them. So have I. And we have responded to some of those concerns by some of this fleshing out of the role of the Federal Reserve.

Senator D'AMATO. Can I assume, then, that these talks are ongoing? Are they continuing? Do we have the constant kind of dialog between Secretary Newman and, let's say, a counterpart at the Fed, someone with——

Secretary BENTSEN. Chairman Greenspan and I discussed this as late as this weekend.

Senator D'AMATO. Will this be ongoing, then?

Secretary BENTSEN. Oh, sure. We will continue to talk.

Senator D'AMATO. That's encouraging to this Senator. I would suggest this, because I'm not going to begin raising the various questions that come to mind. You have attempted in your presentation to address some of the concerns that have been put forth as it relates to the State banks, as it relates to the consolidation of power that the Administration might have, and as it relates to the Fed's role as it addresses systemic risk.

I could go into the fact that it would be 1 out of 5 and what would its voice be there.

But I don't think at this point, that that is most pressing. I think the most pressing would be to urge you to continue, then, to do exactly what you're doing. If you have that ongoing dialog through yourself and/or through Mr. Newman and others with the Fed, continue it, because, I believe, that we'll actually take that and hopefully, the Committee and its resources can act as a catalyst to bring this about so that a meaningful reform package that accomplishes the goals and aims that I think everyone on this Committee has espoused in one way or another, Senator Dodd, Senator Bond, the Chairman, that that is a way of achieving it.

Without that, I think that we could report out a bill, go down to the floor and achieve true gridlock. We want to avoid that and I just urge that the dialog that has been taking place continue. We could advise our staffs as it relates to what progress is being made and maybe even to what points of contention exist.

In the final analysis, it will be our responsibility to take the position. I would rather do so with both of the groups helping to pave the way.

The CHAIRMAN. Senator D'Amato, would you yield to me on that point?

Senator D'AMATO. Certainly.

The CHAIRMAN. Would you agree with me, in the full spirit of what you've just said, that time is of the essence here, and let me just elaborate.

We've produced a number of legislative items out of this Committee. We've got securitization of small business loans.

Senator D'AMATO. I didn't bring that up yet.

The CHAIRMAN. No, but we need to move it ahead. And the same thing with community development banks. We've just passed an interstate proposal out of this Committee. We've got the Export Administration Act to deal with a little bit later in the year.

We are commencing today our hearing schedule, but we'll have a busy schedule the rest of the week to make sure all points of view are heard on this. But I would make this point. I think it's essential that we resolve these issues promptly. This is the kind of an issue where footdragging doesn't achieve any good end. And the status quo is the only thing that is served by footdragging.

So, if you would share the view that it's time to crack these issues apart and find a solution that can meet the broad interests that we've all expressed today, that the time to do that is now, and to do it promptly. Would that be your view?

Senator D'AMATO. My view is, basically, that we've got to get some of these outstanding issues resolved by the two parties. If we don't and if it's going to be an attempt to just push it through, we're not going to be successful.

That's why I'd really urge—and I'm not making any assertion that the kind of dialog has or hasn't taken place. I'm glad to hear that you have been speaking. I'm urging that. My sense is that, without that, we're not going to get the kind of meaningful reform that we want. There are some Members who are very, very concerned. Senator Bennett has raised some concern. Senator Bond has raised some concerns. I know Senator Domenici has some. I believe Senator Dole has some.

That's even beyond this Committee. I think that you'll find that there are some Members on the other side who also have some legitimate concerns.

What we can do, to begin as you have attempted, Mr. Secretary, in saying that you've revised, already, some of your recommendations for legislative enactment, I encourage you to do that.

And, Mr. Chairman, I might make an aside, that I would hope that we could continue as we started this process, in that spirit. Then we can make some progress. Otherwise, I don't see us being able to accomplish this.

Secretary BENTSEN. Let me say in response, Senator, and be a little more direct. What we have seen in response, at least by one of the Governors of the Fed, was an expansion of the authority of the Federal Reserve, an expansion. That was the counteroffer.

We have reduced our authority, substantially, for the Treasury. We've given up authority. We now find ourselves bidding against ourselves, and that's a bit of a problem.

Senator D'AMATO. Mr. Secretary, be assured, I will be here tomorrow and I will, with the same directness—I have not attempted to beat around the bush—but I will suggest to the Fed that they undertake the same course of action that I suggested today, that there should be some review of this matter. I'm not even going to say negotiations. But review the various positions and the way to achieve the legitimate concerns in problems that exist from both sides.

I will be making that suggestion tomorrow, I think, with the Members of our Committee to the Fed, that they not just be able

to sit back and say, well, unless we sign off, there's going to be no legislation. I assure you that's not where I'm coming from.

I'm going to urge that their side undertake the same course of action that you've indicated that you're willing to take and, indeed, have been undertaking.

Mr. NEWMAN. Senator D'Amato, we appreciate that guidance and would be happy to follow up.

I do want to add that during all of these discussions, all of us involved have a great deal of respect for the views of the Fed and genuinely want to understand what their concerns are because we all want this to work well over time. None of us wants to create a system that isn't going to achieve the fundamental objectives in a number of regards.

As Secretary Bentsen mentioned a moment ago, when we first outlined the framework of this proposal at the end of November, we indicated that we expected a role of active participation for the Fed, particularly with respect to the largest banks, but had not yet defined what we meant by that and wanted to use this period of time prior to presenting a specific proposal to you, to talk with the Fed and understand more of what their concerns were.

It's really only today that we are putting forward the proposals that incorporate the results of a number of those discussions.

The Fed, for example, made a very legitimate point that their role in the payment system is a very special one and we agree that they ought to have authority over the payment system.

They made a very legitimate point that it's important for them to have the ability to take action, especially with the very largest banks in the country, in the case of financial difficulties.

We agree with that, and we have proposed to you today to permit the Fed to take independent action in any of the top 20 largest institutions in the country. Actually, that's more authority than they have right now because there are really only 5 out of those top 20 where they actually have direct authority over the banks themselves today.

The Fed also indicated that they felt it was important for them to have an understanding of what was going on in the largest institutions in a very hands-on sense.

We felt that that was a very reasonable public policy objective, and therefore, have proposed today this active participation in examinations of 10 out of the 20, any 10 that the Fed thinks most warrant their attention.

In addition to providing for the Fed taking a lead role in those institutions which are primarily State member banks in which they have historically had the lead, they have indicated that it was important for them to have an understanding, some hands-on interaction, of a cross-section of banks. We have said, fine. Secretary Bentsen indicated they would be welcome to participate with the Federal Banking Commission in a cross-section of banks that are essentially equivalent to the cross-section of banks that they currently are involved in.

I hope that all of these things will help in addressing the kind of substantive concerns that you mentioned. We are certainly absolutely prepared to sit down and talk with the Fed about it further,

and hope to do that, about any substantive concerns that they may have that would affect the health of the banking system.

Senator D'AMATO. Very good.

The CHAIRMAN. If I may just say, before yielding to Senator Dodd.

I think that this has been a very important exchange between Senator D'Amato and you, Mr. Newman.

I think, in light of the data that the Secretary was describing earlier as to what is the current scope of authority of the Fed in this area, that when you penetrate the rhetoric and you get down to the hard facts of the scope of regulation, percentage-wise, in terms of assets and so forth, you start to see a somewhat different picture than you might get if you just listened to the rhetorical arguments.

I think the effort that the Administration is making, a strong effort to listen carefully to the Fed's concerns with the payment system and with systemic risk, are issues that concern us all.

It seems to me that, by having made a good faith effort to respond to those concerns, there arises a different situation than the whole question of protecting a turf area full of regulators and perhaps even trying to expand that number.

When I saw that part of the proposal from the Fed, I must say it was very different than these real issues that go to the heart of the way the banking and financial system work. What it represents is the bureaucratic appetite that all bureaucracies, I think, are susceptible to, and there's no proper foundation for it, other than an effort to—maybe it's a negotiating ploy. But if it's not that, if it's a serious suggestion to expand into an area where we've already got too many people tripping over one another, it really is an unsound argument.

But I appreciate the point that Senator D'Amato has raised.

I want to emphasize again, the time to resolve these issues is now. We don't have an endless amount of time in this legislative session. We've got a busy agenda in this Committee with other issues that are coming down the track, issues that are awaiting action on the Senate floor.

We've got other items unrelated directly to this Committee, health care and other things to deal with later on down the track.

I would hope that after these hearings are done—and we'll hear from the Fed tomorrow. I'm willing to stay in until 6 p.m. tomorrow night so that the Fed can say everything that it needs to say and we'll listen with great attentiveness because I want a system that's going to work well over time, through changes in Administration, changes of parties, changes of personnel at the Fed, etc.

The time to do this is now. The time to make these refinements and revise the structure, is something that we need to do within a fairly short period of time, and I think we can do it. If we continue to work together on a bipartisan basis, with the cooperation of the Administration, and the Fed, I think there's a way to get this issue solved.

It would be a great mistake to let this opportunity pass.

Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman.

Let me again make the point that I was trying to make at the outset, Mr. Secretary. I think that, clearly, the present situation is unacceptable. It sounds to me as though there is some movement here in terms of trying to resolve some of these differences, not necessarily to satisfy, if you will, the individual bureaucracies, but to try to come up with an intelligent response to a very legitimate problem that you've eloquently described in your testimony here this morning.

I would just like to make a couple of observations. One, is that I don't find the Fed response here any more attractive; I think it goes too far.

I'm a little bit concerned that we're at this altar of efficiency for the sake of efficiency, without looking beyond what we're trying to achieve. I would argue that, generally, our present banking system is fairly stable.

Having four regulators who, over the years, have looked at the same situations, the same data, and the same facts, have come up with different assessments. That, obviously, is not healthy, but I would argue that there has been a certain tension created by having some competition within the regulatory scheme.

I'm a bit concerned about the notion of having one regulator where you have one culture, that could either be terribly lax or terribly rigid. There isn't any real response to either that rigidity or that laxity, by having just one entity that's responsible. How do you respond to that criticism?

Secretary BENTSEN. I respond by saying that you have the discipline of the Congress. You have the discipline of this Committee. That you have the oversight of the press. That you have the oversight of the consumers.

And, I would say, by the same token, that you don't need two Federal Reserves to check on each other. You don't need two Securities and Exchange Commissions to compete with each other and check on each other. You don't need two FDA's, where the pharmaceutical companies can see who might be the more lenient.

Those are the concerns that really have to be addressed, I believe.

Senator DODD. Let me use this example. We had the Home Loan Bank Board. We had this Committee. We had this Congress. We had the press. We had the consumer groups.

Secretary BENTSEN. Sure.

Senator DODD. We had one entity.

Secretary BENTSEN. And look what you had. You had the board being, in effect, selected by those people who were being regulated. You had a situation where they had three objectives and three charges, one of them that they were to promote the thrift industry. The other one that they were to make it safe. You had mandates that conflicted, such as supervising and running the insurance fund.

The Administration's proposal avoids those kinds of conflicts. In fact, for the first time, it will eliminate conflicting mandates from banking regulation by separating the core banking functions of supervision, deposit insurance, and monetary policy under separate agencies.

Second, the Bank Board regulated only thrifts, and as the thrift industry got into trouble, the Bank Board had incentives to stretch those rules out, so as to prop up that industry.

The Federal Banking Commission would regulate a variety of institutions. It would not be dependent on any one type. And, again, I say, the Bank Board relied on the regional Federal Home Loan Banks to conduct the examinations. Those regional banks, as I said, were, in turn, run by presidents and boards of directors appointed by the local thrift industry, the same industry the examiners were supervising. The conflict of interest was serious.

Senator DODD. Again, Mr. Chairman, let me make my point here, Mr. Secretary.

I happen to subscribe to the notion that the present system is unacceptable. I think the comparison to Noah's Ark is a clever approach. I suppose you might make a case that we're talking here about some different institutions, some which are federally-insured deposits, others are not, unlike a pharmaceutical company, where a pharmaceutical company is a pharmaceutical company is a pharmaceutical company.

A financial institution can be somewhat different in its make-up and its responsibilities and its relationship to depositors and to the Federal Government.

I'm one who clearly wants to see us clean up a burdensome system. I really raise the question because I'm concerned that this one-culture notion to deal with all of these institutions is worrisome to me. I'm not alone in that regard, obviously, and would hope that we'd be able to see if we can't come up with some approach that would give us some assurance that we'd be able to streamline this process, and at the same time, not get so caught up in the efficiency argument.

I've heard it said, if we wanted an efficient system in this country, we wouldn't have adopted the processes we have. We have a check and balance in our system. A far more efficient system, obviously, would be a benevolent dictator of some kind.

I suppose our Founding Fathers could have lurched in that direction. But they felt very strongly that it wasn't just what we did, but how we did things that was also extremely important.

While it's important to be efficient in the exercise of our responsibilities over financial institutions, I think we've got to be careful that in that desire to achieve efficiency, we don't sacrifice that sense of common good that can come out of a check and balance.

I have a deep regard and respect for what you proposed here and I must tell you, I'm inclined to be supportive of it, but trying to find some ways we might moderate this a bit.

Secretary BENTSEN. I don't want to see us get into competition in laxity, either, where institutions will say, well, they're more lax over there, they're more lenient over there. I'd rather be regulated by that one. That is a concern to me, too, and I really don't want to see that one happen.

Senator DODD. I appreciate that. Thank you, Mr. Chairman.

Mr. NEWMAN. Senator Dodd, if I could add a little bit from the perspective of somebody who was in the industry not all that long ago.

I understand your concern about over centralization.

We have tried to get a balance on the board of different perspectives, the composition of the board that would bring balance to the policies that were taken by the Federal Banking Commission.

In fact, as Secretary Bentsen has pointed out, more diversity of view would exist than is currently represented for 62 percent of the supervision.

There are two other aspects of it which I didn't fully appreciate until I came to Washington, when I was looking from the inside of the industry, rather than understanding the process here.

The first is the inability of the current structure with multiple regulators to deal appropriately with change.

Here we have a financial services business in the real world that is changing very rapidly. Derivatives, which you and Senator Bond were talking about before, are just an example. And you'll hear examples tomorrow, I know, from the regulators themselves about how gridlock has hampered them from instituting regulations that can deal with new instruments as they arrive, and changes in the financial system.

There is a very serious risk that if we go on with this system, as the real world, the real business world, changes rapidly, that we will not have a system that can adapt to the changes satisfactorily, that we will have weaknesses and safety problems that we can't keep up with.

There's also the problem that the existing structure, in some cases, is the worst of both worlds. In some cases, it's overlapping. In other cases, it allows things to slip through the cracks because there are individual regulators who are responsible for only a portion of what, in the real world, is an integrated financial institution.

Nobody sees the entire picture.

As long as we have a structure that divides it up arbitrarily, and doesn't let a single agency look at the entirety of the business the way it's run in the real world, we will have dangers of safety problems slipping through the cracks.

Senator DODD. I appreciate that. Again, I make the point, I'm not in any way advocating that we don't do anything at all. Quite the contrary.

Let me raise this question with you. What is your assessment of the present condition of our banking system? Is it stable or not?

Mr. NEWMAN. Right now, it's in very good health. The profits are very good. And, as Secretary Bentsen mentioned before, that's part of the reason for our being here today.

Senator DODD. I understand.

Mr. NEWMAN. To suggest that we fix the roof while the sun is still shining.

Senator DODD. I know. But we're also sending out signals that there's some real dangers down the road. The question isn't just as it is today, but what you're telling me is, in the absence of changing this, you see some real instabilities in the system.

Mr. NEWMAN. Yes, Senator, unfortunately, I do. The decline of the share of business in the banking industry, as the Secretary mentioned earlier, I think, is a serious problem for this Nation, and I don't see any change in that decline.

Now that I understand more of how things really operate in the regulatory process, I think there is a serious risk of problems for the industry before the end of this decade if we do not change, in an effective way, the regulatory policies.

Senator DODD. I must say, I just read this article by Lawrence Lindsey from the Federal Reserve System. He's now, basically, in favor of more regulators. It's just amazing what happens when people leave the private sector and come to Washington, isn't it?

Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Dodd.

Senator Bond.

Senator BOND. Thank you, Mr. Chairman. I certainly would say that I would share the concerns raised by my friend from Connecticut. I think that those are the kinds of questions that we're going to have to resolve as we move forward and get something done in this area, as I really want to.

Mr. Secretary, I've heard about the extensive discussions that have gone on between your agency and the Federal Reserve on this consolidation regulatory streamlining proposal.

There is a lot of discussion around this building and comment that they think the real pushing force for maintaining the single regulatory authority in the Federal Banking Commission has come from the White House. Has the White House weighed in on this proposal?

Secretary BENTSEN. No.

Senator BOND. No one in the White House has specifically mentioned to you or anyone you know that they want to have a single regulatory banking agency?

Secretary BENTSEN. Senator, to the best of my knowledge, this emanates from Treasury and we're the ones, frankly, that are pushing it, to the very best of my knowledge.

Senator BOND. There has not been any discussion about, or has anyone mentioned the Worthen Banking Corporation, the Worthen Bank of Little Rock, or Worthen Financial Corporation, in that context?

Secretary BENTSEN. No. And let me tell you something. As Chairman of the Oversight Board, by law, I am prohibited from intervening in individual cases. I'm just delighted to be in that position.

Senator BOND. I understand. I wouldn't expect you to be—and I think we all have the greatest confidence in you and there's no question there. But what I was inquiring about was the lobbying or the advocacy either by someone from the White House raising the Worthen Bank, or whether Mr. Curt Bradbury or anybody from Worthen had contacted you or your associates, to your knowledge?

Secretary BENTSEN. Not to my knowledge. What we have is an interagency team led by Treasury on this. But Treasury has been, as far as I can see, the real push on this.

Senator BOND. Mr. Newman, have you had any contacts, either referring to Worthen Banking Corporation or on behalf of any individual from Worthen?

Mr. NEWMAN. Absolutely none whatsoever, Senator. As the Secretary said, this has been led by Treasury. We have had active involvement of other agencies, including the NEC and OMB, as we always do. But it's always been 100 percent in the vein of good

Government. It was on the minds of the National Performance Review team as part of Reinventing Government because it was so obvious that it was a cluttered, inefficient form of Government. That was the only vein in which the other agencies have participated.

Senator BOND. So the White House participation has been limited to OMB?

Mr. NEWMAN. The standard interagency team was OMB, NEC, and the Council of Economic Advisers. And, as I said, in this particular case, the National Performance Review. This was on the list of an entire range of inefficient areas of Government. But it was all in that, absolutely in that vein, Senator.

Senator BOND. And no one outside of those agencies was involved in it from the White House?

Secretary BENTSEN. I've kept the President apprised, certainly, of what we're pushing here. That's part of my responsibility.

Let me say, again, this proposal has no relevance, to my knowledge, to any specific case. I would think by the time this thing was implemented, whatever the case is would be resolved. I would assume it would take a year, year and a half, at least, to do this.

Senator BOND. Mr. Secretary, I accept your assurances. Let me just explain why I was asking. I'm not going to take up time here.

I will submit for the record a brief chronology of the Worthen Banking Corporation and its problems with the Federal Reserve. Worthen Banking Corporation is a $3.7 billion asset holding company in Little Rock. It has had ongoing controversy with the Federal Reserve.

It would, under this proposal, no longer be subjected to Federal Reserve regulation as a bank holding company. Is that correct? It's the 164th largest, but it's $3.7 billion. It would be excluded from the Federal Reserve. Is that correct?

Mr. NEWMAN. That is correct, except to the extent that the Fed would be involved as a member of the board and in its participation role that I mentioned before.

But, Senator, let me again just be very clear. We had no involvement in this whatsoever. Absolutely zero. I didn't even know about this. It was never raised in any of the interagency meetings. It was absolutely not a factor whatsoever in any way in our approach here.

This is 100 percent driven by a desire for good Government, for efficiency, and for us to have a healthier banking system going forward for this country, 100 percent.

Senator BOND. I appreciate your putting that information on the record. I think it's important that we do so.

There was an October 12, 1992, article in the Wall Street Journal quoting Mr. Curt Bradbury, the head of the Worthen Banking Corporation, who had just made a $3.5 million emergency loan to the Clinton campaign after Super Tuesday, saying:

> I would like to be in a position to think I could call the President of the United States and give him my views on the Federal Reserve, for example.

I think it's important that we have the opportunity to clarify the position. That's why I wanted to know specifically.

The CHAIRMAN. Senator Bond, would you yield to me on my time and I'll extend your time?

Senator BOND. Sure.

The CHAIRMAN. First of all, this idea of banking consolidation has been around since the Hoover Commission and the Grace Commission. I don't know whether you were here or not here in my opening statement.

Senator BOND. I've been here all day.

The CHAIRMAN. I thought you had. But, in any event, the idea of banking consolidation predates this Administration by decades. Certainly, the bill that we've been developing predates this Administration.

Any question that you want to raise that you think is appropriate is fair game, and I ask unanimous consent that the document you wanted in the record, be put in the record right now.

But, with respect to the genesis of this consolidation proposal, I don't think any one institution has any particular meaning or relevance to this discussion that we're in, in the sense of trying to restructure the system and put it on a sounder footing for, hopefully, several decades.

Senator BOND. Mr. Chairman, I'm a strong supporter of consolidation. I think there is a very real question which has and will be raised in the press because of the high-profile nature of this particular institution.

We've now had the opportunity to hear from the distinguished Secretary of the Treasury, whose word I trust implicitly, and Mr. Newman that it was not. I think it's important as we go forward on this that we resolve this question.

They have stated very clearly what their position is and I think it is helpful to clarify the air to make sure that they are on record as saying that this is a Treasury proposal.

I have a couple very brief questions about the Federal Reserve proposal.

The CHAIRMAN. Please continue.

Senator BOND. I will be attempting to ask the Federal Reserve what I hope will be tough questions tomorrow on their proposal because I think it's essential we move forward.

Secretary BENTSEN. Senator, I want to be sure we understand. When I say it's the Treasury's proposal, we're the lead agency. We had an interagency team working on this. The NEC was involved in it and they have all been supportive of it, all of it. But we are the lead agency in it. We are the ones that have really been pushing.

Mr. NEWMAN. Also, Senator, just to clarify again. I remember this, personally, very much because it was at my confirmation hearing about a year ago that the Chairman asked me if I would, during the course of my first year in office here, attend to this item and come back with a proposal on it. Then, later in the year, Chairman Riegle and Senator D'Amato actually sent a letter to the President requesting a proposal that would consolidate the four regulatory agencies and we responded to that request.

Senator BOND. May I just suggest, just to get off of this question, if you would submit to us a list of the agencies involved and the personnel, the individuals who are participating in it, then we can have that all in the record and we don't need to go any further into that.

Secretary BENTSEN. We'd be delighted.

Senator BOND. Mr. Secretary, the thing that strikes me about this proposal, the justification is a reduction in the regulatory burden on the banking industry. But I don't hear from the people who affected the bankers back home, any support for it. Do you have any sense of why?

Secretary BENTSEN. I sure do.

Senator BOND. OK.

Secretary BENTSEN. I think there's been a major, major misunderstanding and a misstatement of what we're trying to do here.

I come from that kind of a background. I sat there as the chairman of the board of a community bank. I've served on the board of directors of a large bank. I was in financial services. That's what I did in the private sector.

It's interesting. When you get all of the comments about conflicting regulations and all the complaints from the bankers concerning it, and now some of them have, in effect, come to the conclusion that we're doing away with the dual banking system. Nothing could be farther from the truth. We are not doing that.

Senator BOND. I can assure you that the folks back home don't understand that.

Secretary BENTSEN. They sure don't.

Senator BOND. So we need to do a lot of work.

Secretary BENTSEN. We've got to do some missionary work.

Mr. NEWMAN. Senator, excuse me. Again, on this particular topic, just as an example. I had in my office the State banking commissioner of a large State who was worried that this proposal would take away the ability of his State to have its institutions, its State-chartered institutions, have powers that have been granted to it by that State.

In fact, this proposal doesn't do that at all. As a matter of fact, this proposal doesn't even grant to the Federal Banking Commission any power to tell a State what it may or may not have its State-chartered banks do. That needs to be clarified.

Senator BOND. I think there's a proposal that the Federal Banking Commission would accept State exams for institutions with less than $250 million in assets, health, and well-capitalized. Does this mean such institutions would not be examined by a Federal regulator at all?

Mr. NEWMAN. Yes, that's correct, Senator. If the State chooses to proceed that way, and the State commission was certified, and for those institutions, which is the vast majority of those institutions, that are well-capitalized, then there would be no need for the Federal Banking Commission to be there at all.

The State examiners could take care of it, and there would be no duplication of Federal and State activity. For the larger banks——

Senator BOND. So the Fed—under what conditions would the FBC not regulate State-chartered banks?

Mr. NEWMAN. Let me step back. The current custom is for the very largest institutions, the State bank supervisors and the Federal regulator go in jointly. For the remainder, they typically alternate years.

What we're proposing here is that the customs stay the same for the largest institutions. For the medium-sized institutions, the alternation would continue. For the institutions below $250 million,

as long as the State wanted to have the sole responsibility and had been certified and as long as those institutions were well-capitalized, which is thousands and thousands of institutions, then the State alone could take care of those institutions without interference from the Federal Banking Commission.

Senator BOND. Is there any difference in the impact of regulations under the Federal Reserve proposal which would make the dividing line based on the chartering agency of the lead bank or bank holding company, or any difference in the savings that you would assume from regulatory consolidation?

Mr. NEWMAN. To the best of my knowledge, the Federal Reserve has not included, in their proposal that's been discussed publicly, this kind of a delegation to the State authorities for the smaller institutions.

Clearly, there would be some improvement in efficiency if we take any of these steps. But to have two full-scale regulatory and supervisory authorities would miss an awful lot of the potential efficiencies. For example, under the Federal Reserve's proposal, they would regulate thrifts that happened to be subsidiaries of the holding companies that they were supervising.

The Fed has never supervised thrifts, has no experience, and has no staff with thrift expertise. We would be forced to build up a new duplicate set of thrift expertise at a time when we're already having difficulty in the OTS maintaining a sufficient core of expertise. It just doesn't make sense, Senator.

Senator BOND. Mr. Secretary, Mr. Newman, Mr. Chairman, I appreciate your indulgence as we went through that exercise and I thank you very much for allowing me the time.

The CHAIRMAN. We'll give you as much time as you need. I think it's important that we take these issues one by one.

Let me ask you, Secretary Bentsen, I think it's important we have on the record your response to the argument that if we create a new regulatory agency of this kind, that it could become politicized by whoever happened to be President of the United States. Can you address why you do not see this as a concern?

Secretary BENTSEN. Yes. The FBC will be governed by a five-member board consisting of a chairperson appointed by the President, confirmed by the Senate, the Secretary of the Treasury or his designee, a member of the Federal Reserve Board, and two independent members appointed by the President and confirmed by the Senate.

Board members will have staggered terms. Both major political parties will be represented on the Commission. At least one member appointed by the President will have State bank or thrift regulatory experience. The chair and other appointed members of the FBC can only be removed by the President for specified cause.

At present, the members of the FDIC and Fed Boards and the heads of the OCC and the OTS, are all selected by the President.

The FBC will not expand the number of politically appointed supervisors.

Under the current system, both the OTS and the OCC, which between them supervise over 60 percent of all insured depository institution assets, are bureaus of the Treasury Department.

The new FBC will be independent of the Treasury. Thus, Treasury will give up supervisory authority over the banking system under the Administration's plan.

The CHAIRMAN. Let me move to a different area that I think we also need to deal with, and that's the issue of charter-flipping.

As you know, one major contributing factor in the thrift debacle was inadequate State oversight of thrifts that were granted expanded powers under State laws. In fact, 70 percent of the losses in the entire system came from just two States through their State-chartered institutions.

I'm wondering how your proposal safeguards against the occurrence of federally-chartered institutions flipping to State charters for the purpose of avoiding effective regulation.

The CHAIRMAN. Mr. Newman, do you want to answer that?

Mr. NEWMAN. Mr. Chairman, the basic idea that an institution could change its charter from national to State or State to national would still stay in place under this proposal. That fundamental aspect of the dual banking system would still stay in place.

There would no longer be a different Federal regulator, depending on whether it was a State or national charter. And, therefore, if there were ever a situation under which a bank or a thrift wanted to escape, if you will, thorough implementation of regulation by seeking to get to a Federal regulator that it thought was more lenient, that opportunity would no longer exist.

So, as I mentioned, thousands and thousands of smaller State institutions would not be necessarily involved with any Federal regulator at all. If, in fact, they fell below being well-capitalized, the Federal regulator would be prepared to step in.

The CHAIRMAN. I want to pose two other questions here and get to Senator Domenici as well.

I think it's important, for the record, to know how the structure of your proposal would avoid replicating the problems that we saw in the Federal Home Loan Bank System in its regulation of the thrift industry.

Secretary BENTSEN. I think there's a huge difference. I think one of the reasons is that the old Bank Board had sharply conflicting mandates responsible for promoting the thrift industry, supervising thrifts, and running the insurance fund.

The Administration proposal avoids those kind of conflicts. In fact, the Administration's proposal will, for the first time, eliminate conflicting mandates from banking regulation by separating the core banking functions of supervision, deposit insurance, and monetary policy into separate agencies.

Second, the Bank Board regulated only thrifts. As the thrift industry got into trouble, the Bank Board had incentives to prop up that industry, to stretch the rules. The Federal Banking Commission would regulate a variety of institutions and would not be dependent on any one type.

I think here's another one that's a serious problem for us.

The Bank Board relied on regional Federal home loan banks to conduct the examinations and those regional banks were in turn run by presidents and boards of directors appointed by the local thrift industry, the same industry that the examiners were supervising.

The conflicts of interest were serious, indeed.

The CHAIRMAN. Let me, finally, ask this. Senator D'Amato, you'll be particularly interested in this.

I'm wondering what the process is that you envision now for bridging the gap between the proposal that I've introduced with Senator D'Amato, the Administration's proposal, and what the Federal Reserve has put forward, recognizing, I'll say it one more time, time is very much of the essence. What process do you envision in terms of how we move forward from this point?

Secretary BENTSEN. Mr. Chairman, I think we have moved a long way. As I stated earlier, we made a proposal. We had a proposal by one of the Governors of the Federal Reserve, which some thought might be the Federal Reserve's answer, which expanded their authority substantially.

In this situation, I think I'm probably the only Secretary of the Treasury in history that has given up this much turf. We've got 62 percent of the assets of thrifts and banks that have been under the jurisdiction of Treasury, and that will no longer be the case. That will be turned over to an independent agency.

The problem I've got is we listened to all of these concerns, and we then fleshed this out trying to take care of some of the things that Members of this Committee had said to us before, and that the Federal Reserve has stated. So, I'm in a position now where we'd be bidding against ourselves. We have moved and we presented this.

The CHAIRMAN. Senator D'Amato, Senator Domenici has arrived. Let me yield to you and let you yield to the Senator.

Senator D'AMATO. Mr. Chairman, I yield to Senator Domenici.

OPENING COMMENTS OF SENATOR PETE V. DOMENICI

Senator DOMENICI. First, let me thank you for that.

I'd speak for the record that I couldn't get here any earlier because we're trying to reform this system, Mr. Secretary, where you don't have three meetings at the same time. But we haven't gotten there yet.

Secretary BENTSEN. That will be the day.

Senator DOMENICI. The more we try, the more Senators say, let's leave it like it is.

I want to thank you for your consideration in personally calling me regarding this matter and then sending Mr. Newman up to discuss the matter with me. I'm not sure I had enough time for you, Mr. Newman, but I did learn your view and I must say, I also had Chairman Greenspan up and I learned his view.

Mr. NEWMAN. I appreciate your time, Senator.

Senator DOMENICI. I have four questions.

A lot of us have theoretically said, why do we have this dual bank system? Academicians and people who teach banking are always talking about the duplication of the dual banking system, which kind of grew up accidentally. But, frankly, I think it turns out to be pretty much a strength of the system that we have State charters and we have Federal charters of one sort or another.

First of all, I think of our bankers, in my little State. There are a lot of independents. They're against this approach and I think it's because they think it threatens the dual banking system. And,

frankly, if it did, I would be in their shoes. I would join them, I would think they're right.

Can you tell us, how do we dispel this? What do we do to try to get the point across, that it's not endangering the dual banking system?

Secretary BENTSEN. Senator, I think you made a very valid point. I don't think that we've got the message out to them sufficiently and I think there's a great deal of misunderstanding. It's my hope that as a result of this hearing, and the media covering it, that we'll be able to dispel that kind of idea.

Let me state, the dual banking system is an important part of our banking tradition, and it should remain so. I would not be here if I thought that that was being destroyed or imposed on.

Our proposal will not affect the dual banking system. Our proposal will not give the Federal Government any additional authority over State banks or State regulators. The proposal must and will preserve the 51 different testing grounds that State regulators provide for new ideas. The States will continue to be the primary regulators of banks that they charter.

The Federal regulators will continue to be able to rely on State examinations in alternate years, as under the current law. And, under current law, the FDIC will be the only Federal agency with authority to restrict the activities of State banks. That's the law now.

The Federal Banking Commission will establish a system for certifying State banking departments. It will then place increased reliance on examinations from those States. The Commission, generally, will not duplicate examinations of small, well-capitalized State banks conducted by certified State agencies. Under this approach, almost 60 percent of all State banks will probably be examined only by the State regulators.

The other point that we made before you arrived here, insofar as what we charge in the way of fees on State banks, we excluded those under $1 billion in assets.

Mr. NEWMAN. Excuse me, Senator. One of the things that we tried to listen to carefully, as some of the State bank supervisors themselves suggested, is that it would be helpful to have someone on the board who understood the perspective of State banks.

We thought about that, and we tried to listen, as we said, to good thoughts from a variety of different sources and agreed that that was a good idea. So our proposal does call for one of the independent members to be somebody who either is a State bank supervisor at the moment or has been a State bank supervisor, to bring that perspective.

All of the things that Secretary Bentsen just mentioned, as well as this point, are all new and being proposed really just today.

Senator DOMENICI. Let me then move to Chairman Alan Greenspan, and honestly say to you that, from what I was able to glean from the chairman, it seems that the chairman thinks that the new role of the Federal Reserve and how the Fed will be able to respond in a crisis, is substantially changed.

According to the chairman, if regulatory consolidation reduces the Fed's banking regulatory responsibility, the Fed will not be able to adequately respond to crises in the financial markets.

In talking to me, the chairman gave a number of instances in the past when he believed the ability of the Fed to respond to financial crises was predicated upon hands-on regulatory information from the banks, including some of the small banks that they had. I'm sure he has given you the same information as he gave me.

How will this proposal affect the Fed's ability to respond to a crisis in the banking industry? Is it going to diminish their effectiveness in this area?

I assume you're going to say, no. Anybody who would say, yes, obviously, would be against the proposal. But why is it that the chairman and the Federal Reserve are so concerned about this? I don't believe they're imagining things. I think they did gain some ability to face crises by knowing precisely what was going on. They even call bankers during crises. Could you just tell us your version?

Secretary BENTSEN. Yes. They do not need direct supervision to handle systemic crisis.

I spent the weekend in Germany at the G–7 meeting with central bankers and with Finance Ministers. I visited with the Bundesbank, which is one of the pre-eminent central bankers of Europe. They do not have examinations. They do not have the authority for examinations and they don't want it, and stated that to me.

Let me also say that banks no longer dominate the financial sector. Banks hold only about one-third of financial institution assets. Banks' share of financial institutions' assets have been dropping for two generations. The Fed, therefore, must focus on markets, rather than just banks.

Many of the recent crises in the financial markets were not triggered by banks. The Fed was able to handle the 1987 stock market crash, the Penn Central Railroad bankruptcy, and the Ohio thrift crisis of the early 1980's, without any direct supervisory role in those industries.

Recent statutory changes, namely FDICIA, have further reduced the likelihood that banks will trigger a crisis.

Now the Fed uses the discount window, uses lending, not banking regulations, to battle systemic crisis. And that proposal will not affect the Fed's discount window authority. Will not.

Mr. NEWMAN. Senator, let me just add a little bit of perspective because during some of these periods of time, for example, the 1987 stock crash, I was then the chief financial officer of the second largest bank in the country and very much involved with what was going on.

As Secretary Bentsen just said, the primary role of the Fed, as far as I could see it at that time, was providing liquidity for the system as a whole, being prepared to operate at the discount window, which is done on a collateralized basis and is done to a wide variety of banks, including those that are not under the Fed's direct supervision.

The Fed actually supervises directly only 15 percent of the assets and, actually, only 5 out of the top 20 banks that are most involved in major activities.

In many ways, I actually believe that our proposal would enhance the Fed's ability to do whatever it needs to do during a systemic crisis as part of a team of people dealing with the system be-

cause they would actually be involved in 10 out of the 20, rather than just 5 out of the 20, on an active basis and would have backup authority over all 20 of the top banks where they actually have authority right now only in 5 out of the 20.

Senator DOMENICI. My time is up and both Senator D'Amato and I have to go to a Republican Ranking Members meeting. I want to just say to Secretary Bentsen, in your prepared remarks, you alluded to administrative cost savings that could occur under this form to the banking industry, presumably even the small ones.

Secretary BENTSEN. I also said in there, I don't know if it's 5 or 25 percent insofar as the banking industry itself.

Senator DOMENICI. Right.

Secretary BENTSEN. But I took the report of one of the governors and his evaluation as to what it could be.

Senator DOMENICI. The point I make, though, is that one of the complaints the bankers, especially small ones, have, and I'm sure when you were running for office, you heard the same thing I've heard. I've gone to a small community and in one case, the banker met me at a meeting and he handed me a box, a cardboard box. I said, what's that? He said, well, it's a present. I said, what kind of a present?

I thought you might want to review what this little bank with 11 people has to go through with reference to regulatory applications and the like. This is the one due in the first quarter of the year. The box was this big. The statement was I have to keep one person almost full-time because I have no other source of expertise.

I gather that all of this is being done to make the banks even more efficient so they don't have to waste all that time.

Secretary BENTSEN. It certainly is one of the major objectives, to get rid of the conflicting regulations and overregulation and duplicative regulation to cut the cost.

Senator DOMENICI. The point that worries me is, while we're saying we're going to try to save administrative costs, the OCC hiked fees 3 percent in January.

Secretary BENTSEN. The what?

Senator DOMENICI. The OCC hiked fees 3 percent in January, even where we had competition for services. That's what I'm led to believe. Is that correct, Mr. Chairman?

The CHAIRMAN. Let's inquire.

Mr. NEWMAN. Senator, the problem of keeping up with the costs of regulation, as some of the requirements of recent legislation have come into play, have caused increases in fees. I think that's all the more reason why we need to take steps to try to reduce the costs, rather than let them continually increase.

Senator DOMENICI. Thank you very much.

The CHAIRMAN. Senator Domenici, one of the interesting issues that we were discussing before you arrived, is that these agencies have to cover their costs. They've got to cover these costs by charging examination fees. The Federal Reserve, interestingly, doesn't do that. They don't charge.

So the question is who pays that bill? Well, we know who pays that bill through the Budget Committee. The irony of the situation is, the more supervision you give the Fed, while they're not charging the fees, the more that you, in a sense, increase the operating

offsets to the Fed's revenue and the amount of money coming back into the Treasury.

We can end up driving up the deficit by increasing the supervisory and examination authority of the Fed.

We think we've found a good solution to this problem by decreasing the cost of regulation by eliminating duplication. When you have three different sets of regulators all in the same institution on the same day, all that cost has to be borne in the end by customers of banks and shareholders of banks and so forth.

We'd like to get the cost down, and keep the regulation rational and sensible, because the people that are getting regulated pay that bill, so we don't end up passing it off on the taxpayers when we shouldn't.

Senator DOMENICI. Everything else in the wake of this Constitutional amendment debate is spoken of as something that we just can't do, right?

The CHAIRMAN. Right.

Senator DOMENICI. We've got so many can-dos, that clearly, one ought to vote for the Constitutional amendment just on that basis. If we can't do anything, we ought to try something else.

That's what I'm going to say with a few more facts behind it. But at least this one that you allude to, nobody is saying that we can't fix that policy.

The CHAIRMAN. That's right.

Senator DOMENICI. That's a few million dollars a year, anyway. That's pretty good.

Thank you, Mr. Secretary, for your graciousness in my office in that regard.

The CHAIRMAN. Mr. Secretary, one other question I wanted to have on the record. Is there, in your estimation, any reason why the Fed has to be conducting day-to-day bank examinations in order to conduct monetary policy? Because the Bundesbank in Germany, as I understand it, does the monetary policy but does not do day-to-day, hands-on bank exams.

If we make this change that you're speaking about, isn't it fair to say that this will not impair, in any way, the ability of the Fed to conduct monetary policy.

Secretary BENTSEN. Absolutely not. And I don't want to impair it in any way.

The CHAIRMAN. Nor do I.

Secretary BENTSEN. I have a great respect for the Federal Reserve, and I sure want them to continue to be independent and conduct the monetary policy for our country. I feel that very strongly.

The CHAIRMAN. I think that's another one of those false arguments. I think monetary policy will in fact be strengthened. The Fed's ability to conduct it will be strengthened under the proposal you put on the table today because you've actually given them a better way to monitor what's going on in the system.

One of the most important revelations today, and I hope it isn't lost, is the present limitation on the Fed's bank supervisory role. I believe it has been misportrayed as larger than, in fact, we find it to be when you get right down and look at the bulk of financial assets in this country and who's performing basic regulatory functions.

What the Fed has done is created a picture that they are, in a very overarching way, looking after the banking supervisory needs of the country when, in fact, they have far and away a smaller share that they are responsible for in that area than do other regulators.

And so, that misconception is a very important one to clear up because what we're talking about are changes on the margin in terms of supervision. I think what you've actually done is increase the ability of the Fed to be able to be an effective monitor in those areas where it needs to be from the point of view of systemic risk and the payment system.

Mr. Newman, would you agree with that?

Mr. NEWMAN. Absolutely, Mr. Chairman. The connection between monetary policy and bank supervision is a tenuous one in the first place. And, as Secretary Bentsen mentioned before, it's not the custom in most countries around the world. Some very responsible central banks feel they can conduct their monetary policy fully without having bank supervisory and examination responsibilities.

If anything, our proposal will give the Fed a little bit more information about what's going on in the major banks in a closer way. But even then, that is only a small portion of what the Fed needs to look at in conducting its monetary policy. It needs a far, far broader picture of what's going on, which it obtains from many, many different sources.

The CHAIRMAN. I think that's clear. We conduct oversight of the Fed in this Committee, as you know. We've had the Federal Reserve in any number of times. Of course, when they go through their analysis and it relates to monetary policy, it covers a much wider universe.

Mr. NEWMAN. That's right.

The CHAIRMAN. They would have access to any records that they need. They're absolutely unrestricted in terms of their ability to get their hands on any data. So, if we want to talk about banking data, they can reach that.

This is not an impairment of the Fed. What it comes down to is a bureaucratic issue as to how many people are going to be on whose payroll.

I must say, as I've read some of the comments from Mr. LaWare on this subject, I hear the echo that I heard other times of established bureaucracies and bureaucrats who take the notion of having to streamline or consolidate as an assault, a personal assault.

But it isn't that at all. And in this day and age, there isn't any institution of Government that is beyond this kind of important self-examination.

I think you've made a very substantial accommodation to the issues that they have raised. And, in all due respect, we don't have any perfect bank regulatory agencies. We spent a lot of time in here on BCCI, which was an area under the jurisdiction of the Fed. Somehow or another, as large as that was, they didn't seem to be able to catch it, at least not for a long period of time.

The whole question of the efficacy of any one regulatory agency, I think, is always a fair question.

In any event, you've put a good proposal on the table. It makes sense. I think it will stand the test of time in terms of giving us some positive gains and avoid negative consequences.

I think we don't want to be—this isn't a drive for change just in the name of reshuffling responsibilities or even, "just efficiency," per se.

We want a stronger system. We want to prevent the possible problems of the future by learning our lessons from the past. I thought your point today, Mr. Newman, about the things that fall between these competing jurisdictions, and derivatives, to me, is one very key element of that, is a very major point.

Part of our responsibility is to avoid problems in the future that can come out of this regulatory overlap and gaps in the system.

I can understand why established bureaucracies will fight tooth and nail: Their view is very limited, they only really see their own turf and their own situation.

We have to expect more of that in this situation because the stakes are far higher than that.

I hope that when the Fed comes in tomorrow, they'll show some awareness and sensitivity to that issue. This proposal will strengthen the Fed and, more importantly, it will strengthen our financial system and our ability to monitor it properly, and for that, you're to be greatly congratulated.

Secretary BENTSEN. Thank you very much.

The CHAIRMAN. I thank you both.

The Committee stands in recess.

[Whereupon, at 12:45 p.m., the Committee was recessed.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR CHRISTOPHER J. DODD

Thank you Mr. Chairman. I know how strongly you feel about this issue and I'm looking forward to working with you to pass a regulatory consolidation proposal of some kind this year.

As we begin this series of hearings, I want to stress one point in particular. While there may be large differences on how much consolidation is necessary—some say one regulator is best, others say two or three will do—I think almost all of us can agree on one thing: Whether we streamline the current, inefficient four-regulator system is *not* an open question. The end result of the process we're beginning today cannot be maintenance of the status quo. Some substantial consolidation must occur.

I emphasize this point because there continues to be great polarization on the consolidation issue. I believe we can find a compromise but we have a long way to go. All parties must come to the table. The war of words needs to end, and the consensus building needs to begin.

There is no shortage of ideas to work with. Since the late 1930's numerous studies and proposals have been made. Every few years since, this issue has been reexamined. By now, there is a mountain of material to draw from.

In the coming weeks, I will offer my own suggestions on how I believe we can structure the system. As you know, I have stated some concerns about a single regulator. I believe we can build a two regulator system that will address everyone's interests without the politicization and disruption that would result from a single regulator.

However, in the end, I doubt the idea of any one person or organization will prevail. No side will get everything it wants. There will be compromise. But we will pass a proposal.

Secretary Bentsen, I know you too have strong feelings about the issue of regulatory consolidation and have examined it closely. I look forward to your comments today and to working with you in the coming weeks.

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Secretary Bentsen, thank you for appearing today to testify about an important issue of mutual concern involving the bank regulatory structure. Before the hearing starts, I want to make a statement on a related subject—the threat to the integrity of the RTC's investigation into Madison Guaranty and the need to ensure the independence of financial regulators.

Last Thursday, Deputy Treasury Secretary Altman testified that he initiated a meeting with top White House legal and political advisors to discuss the RTC's investigation into Madison. The list of participants reads like a political "who's who" of the Clinton Administration: Deputy Treasury Secretary, Roger Altman; Treasury General Counsel, Jean Hanson; White House Counsel, Bernard Nussbaum; Deputy Chief of Staff, Harold Ickes; and Hillary Clinton's Chief of Staff, Margaret Williams.

Mr. Altman asked the Committee to believe that the White House "heads-up" was limited to RTC procedures. On Friday, White House Press Secretary, Dee Dee Meyers, claimed that the meeting was "strictly a procedural briefing," and suggested that it was along the lines of what was made available to Congress and the press.

Mr. Chairman, it seems that the White House's spin-control specialists have lost their equilibrium and are spinning out of control. Frankly, Mr. Chairman, I have difficulty accepting Mr. Altman's testimony and the White House reaction. It flies in the face of common sense. The current story about the meeting has a fairy tale quality to it. I believe the meeting was improper and it undermines public confidence in the fairness and impartiality of any RTC investigation.

Mr. Chairman, I spent weeks trying to obtain this very information from the RTC. We received it only after you interceded. I was never offered a briefing from Treasury or RTC officials. To my knowledge, there were no congressional briefings. All Congress received was a two paragraph letter that I regard as the bureaucratic equivalent of tarot cards. For anyone to claim that the RTC gave us a briefing is totally ridiculous.

The Democrats continue to stomp their feet about the need to protect the integrity of the Special Counsel's investigation. I reject the charge that oversight by Congress will automatically jeopardize the efforts of the RTC or the Special Counsel. That is nonsense. Recent disclosures have driven home just how meaningless these charges are. It is exactly the opposite. *Only* through congressional hearings did the Committee learn of a *real threat* to the integrity of the RTC's investigation—the possibility of White House interference. The source of the threat is *not* congressional inquiry,

but high-level, off-the-record "heads-up" meetings between top Administration officials and White House legal and political experts.

Mr. Chairman, *only* continued congressional oversight can provide assurances to the American people that investigations will not be compromised. Independent agencies *must* be independent—and Congress must make sure that they are allowed to operate independently.

In light of last weeks' shocking revelations, I believe the Senate Banking Committee should convene a fact-finding hearing into the White House meeting. The American people and Congress have the right to know the "who's, why's, what's, and where's" of this meeting. Again, we are just looking for the facts and for answers to troublesome questions raised by Mr. Altman's apparent lapse of judgment.

Here are a few:

- Why does White House Counsel Mr. Nussbaum need to be briefed on the RTC's investigation of Madison? This investigation does not touch upon the President in his official capacity. Is Mr. Nussbaum operating well beyond the scope of his official authority?
- And what about Mr. Ickes and Ms. Williams? There is absolutely no reason these political operatives need to be briefed by a top agency official on an investigation—what does this investigation have to do with the Executive Office of the President? The answer may be that one of Mr. Ickes' primary responsibilities is Whitewater "damage control," according to the *Washington Post* (2/26/94). Ms. Williams, a former Democratic National Committee operative, had earlier joined Mr. Nussbaum in searching Vincent Foster's office. Why do they need a "heads-up"? Certainly not to *help* with an investigation.
- Why was Mr. Altman accompanied by the Treasury General Counsel when the meeting dealt with subjects within the RTC's authority?
- Was the RTC General Counsel advised of this meeting? Was the RTC General Counsel asked to attend? Did the RTC General Counsel refuse to attend? Was the RTC General Counsel or any RTC staff required to brief the meeting participants prior to the meeting? Did anyone brief the participants in preparation for the meeting? Were any documents used to prepare for this meeting?
- Who was involved in setting up this meeting? Are there any letters, memos, or phone logs that substantiate this?
- What was the exact date of the meeting? Who decided who the participants would be? How long did the meeting last? Were notes taken? Was the meeting recorded or transcribed?
- Were any confidential or non-confidential RTC or law enforcement documents or other materials used during the briefing?
- Were any memos prepared summarizing the meeting? Who did the participants subsequently discuss this meeting with?
- Why hadn't Mr. Altman recused himself earlier to avoid such a potentially compromising situation?
- What was the nature of the conversation or comments made at the meeting?
- Was there any discussion of holding subsequent meetings?
- Mr. Altman testified that, "It is not uncommon for meetings of that type to take place." Have other briefings of this nature on Whitewater-Madison taken place? On any other RTC investigations?

Secretary Bentsen, this meeting was improper. Mr. Altman should have known better than to organize it, and the General Counsel of the Treasury Department certainly should have recognized the impropriety of such a meeting.

Mr. Chairman, following Mr. Altman's shocking disclosure, I believe the Committee has a duty to hold hearings to get to the bottom of this matter. The American people and Congress have every right to know that the standards of justice applied on Main Street are also applied at 1600 Pennsylvania Avenue. The Constitution vests Congress with oversight powers. We must exercise those powers—even if it means subpoenaing documents and placing witnesses under oath. The Congress must make sure that the independent agencies are free to enforce the law without any outside interference.

PREPARED STATEMENT OF LLOYD BENTSEN

SECRETARY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

I. Introduction

Mr. Chairman and Members of the Committee, I want to thank you for the opportunity to appear before you today to present the Administration's proposal to con-

solidate the Federal banking agencies. I want to express our appreciation to the Chairman and Senator D'Amato for inviting the Administration to formulate this proposal, which will meaningfully reform the way we supervise our Nation's banking and thrift industries. In the past year, I have had the privilege of appearing before the Members of this Committee—my former colleagues—to discuss a wide variety of matters, but in the end, I think few of those discussions could be more important than the matter we will address today. From my own experience here in the Senate, I also appreciate that, despite the resounding logic of the Administration's plan, there will be some controversy regarding certain aspects of the proposal that will be challenging for you to resolve.

Consolidation of the Federal banking agencies presents a unique opportunity to rebuild a part of America's economic infrastructure that has become badly outmoded, and to make Government more effective and efficient in a way that is meaningful to all Americans. The current Federal bank regulatory structure is senselessly convoluted, places a serious drag on the Nation's banking industry and the economy in general, has failed to effectively protect the stability of the banking system, and ill serves the financial services needs of the American people.

If that were not reason enough for reform, the present system also has another, insidious impact that should especially concern you. The current regulatory scheme enables banking organizations to shop for the most lenient regulator. Thus, the more faithfully an agency implements the laws enacted by Congress, the more likely the institutions it regulates will look for another regulator. You should not tolerate a regulatory system whose structure inevitably saps the effectiveness of the laws you pass.

Today, four different Federal agencies regulate and supervise depository institutions that are insured by the Federal Deposit Insurance Corporation (FDIC). The Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises national banks. The Board of Governors of the Federal Reserve System and the Federal Reserve Banks (referred to collectively as the Federal Reserve) regulate and supervise bank holding companies and State-chartered banks that are members of the Federal Reserve System. The Federal Reserve, as well as the OCC, also have certain responsibilities for regulating and supervising foreign banks' U.S. operations and U.S. banks' foreign operations. The FDIC, in addition to insuring deposits, regulates and supervises State-chartered banks that are not members of the Federal Reserve System.[1] The Office of Thrift Supervision (OTS) charters, regulates, and supervises Federal savings associations, and regulates and supervises savings and loan holding companies and State-chartered savings associations. (See Appendix A for a depiction of the current Federal regulatory structure.)[2]

Trapped in this maze of bureaucracies, most banking organizations are subject to redundant demands, overlapping supervision, and often inconsistent regulation by two, three, or even all four of the Federal regulatory agencies.[3] The system was aptly described in a 1973 staff report to the House Committee on Banking and Currency as a "patchwork structure of regulation consisting of a battery of contradictory agencies which have often reduced supervision of financial institutions to the lowest common denominator among their conflicting positions."[4] In the two decades since that report appeared, these problems have grown worse. Today, over 70 percent of the Nation's commercial bank assets are held by organizations that are supervised and regulated by at least two different Federal banking agencies and almost one half are supervised and regulated by three or four agencies.

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[1] The FDIC also has backup enforcement authority to stop unsafe practices at any FDIC-insured institution if the institution's primary Federal regulator fails to do so.

[2] A more comprehensive chart published by the Federal Reserve Bank of New York, entitled "Depository Institutions and Their Regulators," uses 12 columns, 17 lines, and 31 footnotes to explain which regulator handles what.

[3] As Chairman Riegle has observed, "no thoughtful person would ever design such a system from scratch." Instead, the structure arose over time as the Federal Government, in response to crises and changing needs, established new agencies and expanded existing agencies' responsibilities without ever significantly rationalizing and simplifying the overall structure. For example, Congress created the OCC in 1863 to provide a system of federally chartered banks that would help the Union to finance the Civil War. It established the Federal Reserve System in 1913 to stabilize the economy after a series of banking panics. It created the FDIC in 1933, after the banking system collapsed during the Great Depression. The following year, it extended Federal regulation and deposit insurance to the thrift industry through the Federal Home Loan Bank Board, which became the OTS in 1989, and the now-defunct Federal Savings and Loan Insurance Corporation. It instituted holding company regulation in 1956 for banks and in 1968 for savings associations. It applied Federal regulation to foreign banks in 1978.

[4] *Staff Report of the Subcommittee on Domestic Finance of the House Committee on Banking and Currency, Financial Institutions: Reform and the Public Interest* 5 (Comm. Print 1975).

Given its duplication, waste, and confusion, this system would be ripe for reform even if it had a strong record of preserving bank safety. But it does not. Our country has just emerged from its worst financial crisis since The Great Depression. One of the lessons of that crisis is that our bank regulatory system is cumbersome and antiquated. It did not adequately anticipate or help resolve the recent crisis.

Under the Regulatory Consolidation Act of 1994 (Consolidation Act) proposed by the Administration, bank and thrift resources that are now dedicated to coping with inconsistent and redundant regulation under the current scheme can be redirected to productive uses, such as meeting the needs of customers and the demands of global competition. In addition, the regulatory system proposed by the Administration will be more effective than the current patchwork of regulators in protecting the safety and soundness of the banking system.

On its face, consolidating Federal agency functions appears to be an obvious thing to do. But, as a former Senator, I know how challenging this issue is for you. Congress has grappled with the issue of banking agency consolidation for years. I appreciate that there are those who argue to you that the status quo should not be disturbed; that any change affecting certain regulatory functions will risk various unfortunate results. I understand your concern about the consequences of change, and I do not dismiss the claims you are hearing. I say we need to examine them.

An astonishingly diverse array of observers agree that our current bank regulatory system is "broken." If we fail to fix it now, the next financial crisis we face will again reveal its flaws. And who suffers then? Our banking industry, our economy, and, potentially, the taxpayers. You have the chance to help prevent that result.

I am sure you have many questions about the Administration's proposal. Under Secretary Newman and I are here to explain the proposal and answer your questions. I am confident that once we probe the concerns you have heard expressed about our proposal, you will conclude that the real risk lies not in change, but in missing this opportunity to affect badly needed reform.

II. The Administration's Proposal

The Consolidation Act will combine the regulatory and supervisory functions of the OCC, the Federal Reserve, the FDIC, and the OTS into a new independent agency, the Federal Banking Commission (FBC). The proposal incorporates many of the highly constructive elements of the well-considered bills introduced in the Senate and House, in particular, S. 1633, introduced by you, Mr. Chairman, and Senator D'Amato, and H.R. 1214, sponsored by Chairman Gonzalez and 12 other Members of the House Banking Committee. The Administration's plan also builds upon the many previous proposals for regulatory consolidation that have emerged over the past 45 years.[5] Like the congressional proposals, the Consolidation Act will attack redundancy and waste in Government by realigning the banking and thrift regulators according to their core functions of bank regulator, central bank, and deposit insurer.

A. THE CORE FUNCTIONS OF REGULATOR, CENTRAL BANK, AND DEPOSIT INSURER WILL REMAIN INTACT AT SEPARATE AGENCIES

Under the Consolidation Act, the banking regulatory system will consist of a strong and stable three-part structure based upon core agency functions that complement each other. The Federal Banking Commission will regulate and supervise all federally-insured banks and thrifts, all bank and thrift holding companies, U.S. banks' foreign operations, and foreign banks' U.S. operations. The FBC also will charter national banks and Federal savings associations. The FBC thus will carry out all the functions currently exercised by the OCC and OTS, as well as the FDIC's functions as primary Federal overseer of State nonmember banks and the Federal Reserve's functions as primary Federal overseer of bank holding companies, State member banks, and foreign banks. (See Appendix B for a depiction of the proposed Federal regulatory structure.) The core functions of the Federal Reserve and FDIC will not be disturbed. This is an important component of the Administration's plan that has been much misunderstood.

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[5] Virtually every study of our Federal banking regulatory system since 1949 has recognized the need for major consolidation. Proponents of consolidation have included a task force of the Commission on Organization of the Executive Branch of Government, commonly known as the Hoover Commission (1949); the Commission on Money and Credit (1961); House Banking Committee Chairman Wright Patman (1965); the Hunt Commission (1971); the House Banking Committee's Study of Financial Institutions in the Nation's Economy (1975); Senate Banking Committee Chairman Proxmire (1975); the Private Survey on Cost Control, commonly known as the Grace Commission (1983); Vice President Bush's Task Group on Regulation of Financial Services (1984); and the Bush Administration (1991).

Nothing in the Administration's proposal will affect the Federal Reserve's independence, deprive it of needed information, or hamper the performance of its essential functions. The Federal Reserve, as the Nation's central bank, will continue to conduct monetary policy, administer the payments system, set bank reserve requirements, and provide liquidity through the discount window. It will retain full rulemaking and other authority necessary to carry out those responsibilities. It will still participate in market oversight of Government securities dealers and brokers as part of its responsibilities for open market operations. In addition, it will participate in FBC examinations of certain banking organizations that the Federal Reserve concludes it needs to examine because of the relationship of those operations to the Federal Reserve's monetary policy, payments system, and discount window functions. This includes examinations of national banks that the Fed does not presently have an opportunity to inspect.

The Federal Reserve's participation in examinations will be meaningful. From the Nation's 20 largest banking organizations, the Federal Reserve will select annually, for joint examinations, up to 10 banking organizations (whose subsidiary insured depository institutions could, in the aggregate, hold up to 25 percent of the total assets of all FDIC-insured depository institutions). The Federal Reserve and the FBC will jointly examine those banking organizations. Federal Reserve staff will be actively involved in planning the scope, timing, and their role in the joint examinations. Federal Reserve examiners will also participate in meetings between FBC examiners and senior management as well as the board of directors of banking organizations when examination findings are discussed and transmitted.

Generally, joint examinations will be conducted under the direction of the relevant FBC examiner-in-charge. However, the Federal Reserve could elect to lead the examinations of banking organizations (with up to 10 percent of the total assets of all FDIC-insured depository institution-) that have a majority of their assets in State member banks.

The Federal Reserve could also join in examining an array of smaller State member banks, with up to 5 percent of the total assets of FDIC-insured depository institutions.

In addition to authorizing the Federal Reserve to examine a cross-section of both large and small banking organizations jointly with the FBC, the Consolidation Act gives the Federal Reserve backup enforcement authority to correct actual or potential safety and soundness problems at the Nation's 20 largest banking organizations. The Federal Reserve will be able to initiate backup enforcement action against any such institution by submitting in writing to the FBC a recommendation that it take enforcement action against the particular institution. If, in the judgment of the Federal Reserve, the FBC fails to take appropriate action, the Federal Reserve could institute its own enforcement action if the Board of Governors determines either that (1) the institution is in an unsafe or unsound condition or, (2) the institution's current practices, if allowed to continue, will likely render the institution unsafe or unsound. This backup enforcement authority would be reinforced by the Federal Reserve's seat on the FBC board, which would inextricably link the two agencies and give the Federal Reserve a continuing role in all the FBC's activities.

The FDIC will continue to insure deposits at all federally-insured banks and thrifts. It will continue to grant, suspend, and terminate deposit insurance. It will be able to conduct its own special examinations of insured institutions, where necessary, to protect the deposit insurance fund and take "backup" enforcement action to stop unsafe practices if the FBC will not do so. It also will retain its current roles as deposit insurer overseeing activities of State banks and thrifts that could pose risks to the insurance funds and carrying out the prompt corrective action statute (*e.g.*, helping determine whether a critically undercapitalized institution should remain open), and will retain responsibility for resolving bank and thrift failures at the least cost to the insurance funds.

The Federal Reserve and the FDIC will have full access to bank and thrift supervisory information so they will be able to make independent judgments on matters bearing on their core functions. The FBC will be required to provide the Federal Reserve and the FDIC with timely and accurate information on the condition of the banking and thrift industries and on individual depository institutions.

In essence, the Administration's proposal creates a three-part structure of banking industry oversight. Like the legs of a sturdy three-legged stool, each agency will have important, independent functions and strengths, and each will complement the others to create a stable, effective regulatory structure. The new regulatory structure will oversee the safety and soundness of the banking industry and guard against risks to the banking system far more effectively than the current mixup of regulators.

B. States Will Continue to Regulate State-Chartered Banks, Thereby Preserving the Dual Banking System

The dual banking system will not be weakened by establishment of the FBC. I would not be here before you if I thought the Administration's proposal would have that result. In fact, rather than *harm* the dual banking system, State banks and State regulators will both *benefit* under the Consolidation Act. They will have to deal with only one Federal agency to resolve supervisory issues and may benefit from the broader perspectives and reduced entrenchment of interests that a single regulator system will provide. In particular, State regulators will have the opportunity to play an *enhanced* role in the supervision of their State-chartered institutions.

Concerns that the dual banking system would be undermined because the FBC would have a tendency to regulate State banks in the same manner as national banks and not fully preserve their statutory differences, misunderstand the Administration's proposal and mistake the powers of the FBC.

The Consolidation Act does not try to displace the States as primary regulators of the banks they charter. Nothing in the Consolidation Act will give the Federal Government any additional authority over State-chartered banks or State bank regulators,[6] and nothing will prevent an institution from seeking a State, rather than a Federal, charter.

Under the Administration's plan, the FBC will certify State banking departments that have demonstrated the ability to conduct satisfactory examinations.[7] The FBC will place increased reliance on examinations by certified States. In particular, the FBC will not duplicate examinations of well-capitalized State-chartered institutions with less than $250 million in assets.[8] Thousands of State-chartered institutions will fall into this category.

Even if the FBC wanted to discriminate against State-chartered institutions, it simply could not do so. Under the Administration's proposal, it *is not possible* for the FBC to regulate State banks in the same manner as national banks, and to homogenize their powers, as some have asserted. Nothing in the Administration's proposal authorizes the FBC to override State law to limit State bank powers. The closest thing to that type of authority is the ability of the FDIC today to limit activities of State banks that are not permissible for national banks if the FDIC believes the activity presents risk to the insurance fund.[9] This is a deposit insurance-related power that would *remain with the FDIC* under the Administration's proposal. Nor will the FBC have the ability to re-interpret State law to override existing State precedents or to construe State law one way when State authorities say it means something else. In short, nothing in the Consolidation Act would enable the FBC to take the sort of action that critics of the Administration's proposal regard as threatening to the dual banking system.

To be blunt, I see critics of the Administration's proposal confusing the "dual banking system" with having a choice between different *Federal* regulators. The Administration's plan will preserve the former, but eliminate the latter. Arguments that preservation of the dual banking system requires a choice between two or more *Federal* regulators are really arguments for retaining the ability for institutions to arbitrage Federal supervision. We need to face the fact that having multiple Federal regulators preserves the risk that the regulators will engage in "competition in laxity" to preserve their "share of the market." This does not promote safety and soundness and, in fact, is a key reason to consolidate the agencies. Allowing institutions to seek the most lenient regulator also undermines the legislative process. The banking agency that most faithfully enforces laws passed by Congress loses its market share to the agencies that "go easy" on the institutions they regulate.

The Administration's plan will give institutions a meaningful choice between having a State or a Federal charter and, consequently, a choice between having a State or Federal agency as a primary regulator. But, institutions should not, and under the Consolidation Act will not, have the opportunity to play one Federal regulator off against another.

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[6] The FDIC will retain its authority to restrict activities by insured State-chartered institutions that may present unacceptable risks to the Federal deposit insurance fund.

[7] At present, the Federal Reserve and the FDIC each accept examination results from 35 State banking agencies.

[8] Periodic Federal examinations would still be required for larger banks and small State-chartered banks that are in weaker condition.

[9] 12 U.S.C. § 1831a.

C. The FBC Structure Will Provide an Appropriate Balance Between Independence and Accountability

The board of the FBC will have five members: the Secretary of the Treasury (or the Secretary's designee); a member of the Board of Governors of the Federal Reserve, designated by the Federal Reserve and acting as its representative; and three members appointed by the President and confirmed by the Senate. One of the three appointed members will be specifically appointed and confirmed as Chairperson of the Commission, and will serve a 4-year term (both as a member and as Chairperson) expiring on the last day of March following a Presidential election. The two other appointed members will serve staggered 5-year terms. One of these two members must be from another political party. The three appointed members could be removed from office only for cause. Of the three appointed members, one must be experienced in supervising State-chartered institutions. The Commission will select its own Vice Chairperson.

The FBC will be an independent agency, unlike the present OCC and the OTS, which are bureaus of the Treasury Department. Thus, although the Treasury Department will be represented on the FBC board, the Treasury Department will actually give up supervisory authority over the banking system. The Administration believes this governing structure will properly balance the need for independence in regulatory action with responsibility to the electorate through a continuing Executive Branch role.

The five-member board will provide the right balance between, on the one hand, ensuring the FBC will be receptive to diverse perspectives, and on the other hand, having a board of manageable size that can function smoothly and allow individual board members to be held accountable for their decisions.

III. The Need for Banking Agency Consolidation

Mr. Chairman, Members of the Committee, in the months and years ahead, I do not want to have to appear before you, as my predecessor did, to ask you to take drastic and costly measures in order to contain a banking or thrift crisis. Rather, I want us to take action now, while we have such a good opportunity, so that none of us will be forced to act with a gun to our heads. You have heard that changing the status quo entails risks. The greater risk however, is to do nothing and continue with a dilapidated regulatory system that is ill-designed to *prevent* future banking crises and ill-equipped to *cope with* crises when they occur.

We need a Federal regulator that can focus on our Nation's banking industry. We need a full-time banking regulator that will have the responsibility and authority to keep this vital part of our financial system healthy. The FDIC's focus should be on deposit insurance, not the myriad of other regulatory issues concerning the banking industry, and the Federal Reserve's focus is necessarily and should be foremost on monetary policy.

Regulatory consolidation is an important and necessary step in rebuilding the infrastructure of the American economy. Every American deserves a place to save, to borrow, and to invest. A healthy banking system performs these functions and is a critical component to a robust economy. Overlapping and inconsistent regulation has imposed excessive regulatory costs and burdens on the banking industry. The excess costs are passed on—in some form—to customers. The excess burdens stifle innovation, repress economic growth, and, over the past two decades, have contributed to a significant shrinkage of the industry.

Over the past 20 years, the percentage of our Nation's credit market assets that are managed by depository institutions has shrunk from 62 percent to just 36 percent, the lowest level in history. This transformation may have limited consequences for Fortune 500 companies that can tap the Wall Street and international credit markets. But when the source of financial products and services moves from Main Street to Wall Street, there are important consequences for most Americans.

For most people, the ability to go to college, to start a business, or to buy a home depends on whether they can get a loan. As one banker quoted in Martin Mayer's classic book, *The Bankers*, starkly put it, the actions of banks "determine who will succeed and who will fail."[10] If the banking industry continues its decline, where will these opportunities come from?

For savers, this trend of declining market share means more reliance on investments in place of federally-insured deposits and a relative contraction of the Federal deposit insurance safety net. For borrowers, this trend means reduced credit availability, particularly for small- and medium-sized businesses. It also means more standardized credit terms. At present, when a bank wants to offer a new product

[10] M. Mayer, *The Bankers*, p. 24 (1974).

or service to its customers, it often must weave through multiple regulators to obtain the necessary approvals. This increases the cost of new products and services and stifles innovation. Banks now must devote resources to regulatory compliance that they could otherwise apply to meeting customer needs and reducing costs.

Small businesses also suffer as the role of banks vis-à-vis other financial services providers continues to shrink. Small businesses are the principal source of new jobs for Americans. In fact, from 1988 through 1990, small businesses created all of the net new jobs in the economy. But these businesses are heavily dependent on the banking industry for credit. Absent the major structural reforms set forth in the Consolidation Act, the regulatory burdens created by the duplication, waste, and confusion of having four banking agencies will further sap the vitality of the Nation's economy and narrow the opportunities the banking system can provide to emerging businesses and the American people.

The purpose of the Administration's plan is not to shuffle responsibilities from one Federal bureaucracy to another. I would not waste your time or mine on any such proposal. Rather, the Consolidation Act seeks to establish a regulatory system that will efficiently oversee the banking industry's safety and soundness and support the vital role banks play in the domestic and global economies.

IV. Benefits of the Consolidation Proposal

The Administration's proposal for consolidating the Federal banking agencies has many undeniable benefits. It will improve the quality of the regulation and supervision of our banking system and eliminate inconsistent interpretations of the same laws and rules. It will increase the accountability for regulating financial institutions, providing a focal point for Administration, congressional, and public concerns. The Consolidation Act also will eliminate the potential conflicts of interest inherent in the present system and ultimately reduce Government and industry expenses, benefiting banks, thrifts, consumers, and the economy as a whole.

A. CONSOLIDATION WILL IMPROVE THE SUPERVISION OF THE FINANCIAL SERVICES INDUSTRY

Today, because each banking agency is responsible for supervising just a part of the financial services industry, the supervision of most banking organizations, including virtually all of our Nation's largest organizations, is conducted by more than one Federal agency. Each agency examines and supervises just a part of the typical banking organization. For example, a holding company that controls a national bank, a State nonmember bank, and a thrift, is regulated by all four of the Federal banking agencies. The Federal Reserve supervises the holding company, the OCC supervises the national bank, the FDIC supervises the State nonmember bank, and the OTS supervises the thrift. As of September 1993, there were 28 holding companies with *$743 billion* in assets in exactly this position. In these and similar instances, each regulator relies upon the other regulators for information regarding the parts of the banking organization for which it is not responsible. Incredibly, there are literally *thousands* of cases where our current system requires a separate bank holding company regulator that does not regulate *any* of the holding company's subsidiary banks or thrifts.

This fragmented approach to supervising and examining a banking organization ignores the modern realities of how banking organizations operate and hinders the agencies from obtaining a complete and accurate picture of what is really happening. Transactions between related entities that are supervised by different regulators can escape adequate scrutiny since no one agency sees—much less understands—the organization as a whole. Supervision is particularly difficult when the responsibility is divided between three or four agencies.

Like the classic Indian fable of the three blind men and the elephant, each of the Federal banking agencies examines only a part of any large banking organization and only a fraction of the overall banking industry. The blind man who felt the elephant's leg thought he was standing beside a tree, the man who felt the trunk thought he was holding a snake, and the man who touched the tail thought it was a rope. Under today's bank regulatory system, any one regulator may see only a limited piece of a dynamic, integrated banking organization, when a larger perspective is crucial both for effective supervision of the particular organization and for an understanding of broader industry conditions and trends.[11] No one can credibly argue that the current, segregated approach to regulation is the most effective way to

[11] Although the Federal Reserve supervises bank holding companies, it does not supervise most of the banking subsidiaries of such organizations. Accordingly, it often does not directly acquire any information about the banks owned by the holding companies under its supervision.

guard against risk to individual banking organizations or the banking system as a whole.

Under the Consolidation Act, banks and their holding companies and other affiliates will be supervised as a unit, eliminating inefficiencies and potential blind spots in supervisory oversight, and providing the FBC with multi-dimensional perspectives on individual banking organizations and the banking industry.

B. Consolidation Will Eliminate Inconsistent Regulation

The Administration's proposal will eliminate inconsistencies in bank regulation. Since banks and thrifts will no longer suffer or benefit from the different application of enforcement standards or other policies of the separate agencies, consolidation will end the practice of "regulator shopping," where institutions change the character of their charters to come under the jurisdiction of a more lenient Federal regulator. Charter decisions will be made on their merits. Today, regulators are sometimes inhibited from taking the most appropriate action by the knowledge that the action could prompt an institution to switch charters to obtain a more lenient Federal regulator. Of course, as already discussed, the Consolidation Act preserves the dual banking system and consequently will not prevent an institution from choosing between having a State or Federal agency as its primary regulator.

Beyond the problem of Federal regulator shopping, the multiplicity of regulators creates countless headaches, particularly for banking organizations that must reconcile inconsistent regulatory decisions, substantive standards, and procedural requirements applied to their subsidiary organizations by different regulators. The agencies sometimes apply different rules to similar situations and sometimes apply the same rules differently. The Consolidation Act will provide a comprehensive and coordinated mechanism for enforcing applicable laws and regulations.

In addition, since banking regulations will be consolidated into one agency, there will be no need to coordinate policies and regulations among different agencies. These efforts at coordination can take months, indeed, years, and involve hundreds of people in complex negotiations. In the end, the efforts frequently fail. In recent years, it has sometimes literally taken an Act of Congress to get the agencies to coordinate.

With consolidation, the long delays inherent in the interagency coordination process will disappear, allowing more rapid resolution of significant policy questions. The quality of regulatory decisions and rulemaking also will likely improve because agencies with different (and sometimes competing) agendas will no longer have to negotiate and settle for compromise positions.

C. A Consolidated Agency Will Be More Accountable to Congress, the Public, and the Industry

Consolidation of the Federal banking agencies will increase the accountability of the regulators to the public. Today, when complaints arise in the industry, the various agencies can side-step public and political accountability by pointing fingers at each other. And any regulator who assumes responsibility has only limited ability to influence the overall structure and effectiveness of the Federal supervisory system. With a consolidated agency, the Congress, the public, and the industry will know where to direct their questions and concerns and from whom to expect action.

The structural flaws of the current system are not theoretical. In the mid-1980's, the warning signs were clear that banks had overinvested in commercial real estate loans, but the regulators could not agree on a unified strategy to address the problem. As we all know, this failure to take responsibility and act led to enormous financial losses.

The Government and industry will not be the only ones to benefit from a single, accountable agency. The public and public interest groups, which cannot afford banking lawyers to guide them through the existing regulatory maze, will be able to go straight to the FBC with their comments and complaints. Few consumers now know which Federal agency they should contact if they have a problem with their bank or thrift. Institutions such as the Federal Financial Institutions Examination Council have been unable to address the day-to-day concerns of consumers. Even basic Community Reinvestment Act information has not been available in one place because each agency has a different method for compiling and storing the information. A single regulator will eliminate these problems.

D. Consolidation Will Eliminate Potential Conflicts Presented When Agencies Perform Dual Roles

The Administration's proposal addresses the inherent conflicts of interest and focus that can arise when an agency has more than one core function. Under the current structure, the Federal Reserve Board, as the central bank, and the FDIC,

as the insurer of bank deposits, both face such potential conflicts when they wear their bank supervisory hats.

The Federal Reserve's primary mission is to oversee monetary policy, but it also has bank supervisory duties. There are at least three ways in which monetary policy and supervisory functions may conflict: (1) bank examinations may conflict with countercyclical monetary policy; (2) the two functions compete for the time and energy of policymakers, with bank regulation always taking a back seat to monetary policy; and (3) implementation of both functions by the same agency may involve conflicts of interest with the result that the goals of one are subverted to those of the other.[12] This combination presents potential conflicts.

As former Federal Reserve Board Vice Chairman J.L. Robertson stated, "In appraising the soundness of loans or investments, bank examiners should never be obliged to switch from rose-colored glasses to black ones, and back and forth again, in an effort to implement the monetary policy of the moment."[13] Banks and the businesses they deal with need consistent direction and advice—not policies that will be tugged by macroeconomic cycles. Regulatory and supervisory policy should be a matter of safety and soundness.

The FDIC's primary role is to insure bank deposits, so it also has potential conflicts when it supervises banks. The FDIC, as insurer, has incentives to resist banking innovations if the insurance fund is solvent. These innovations, however, may be exactly the changes banks need to pursue to be responsive to evolving customer needs and to ensure a healthy future. On the other hand, if the insurance fund nears insolvency, the insurer has incentives to forbear.

In the 1980's, the Federal Home Loan Bank Board (FHLBB) was saddled with conflicting mandates similar to those the FDIC and Federal Reserve have today. Like the FDIC, the FHLBB was responsible for both supervising the thrift industry and protecting the thrift insurance fund. The FHLBB thrift examiners were employed by the regional Federal Home Loan Banks. These banks were run by presidents and boards of directors who were in turn appointed by the local thrift industry. The conflicting insurance functions along with the structure of the thrift examination staff produced an institutional bias in favor of forbearance and loose regulatory control. This eventually led to the massive thrift crisis in the 1980's.[14]

Agencies that are forced to wear two hats still have only one head. Conflicts of responsibilities and focus are inherent in these situations. By realigning bank and thrift regulators according to their core functions, the Consolidation Act will eliminate these potential conflicts.

E. Consolidation Will Reduce Government and Industry Expenses

The Consolidation Act is an important component of the Administration's overall agenda of reinventing Government—creating a Government that works better and costs less. Under the current system, each of the four Federal banking agencies has its own team of examiners, its own bureaucracy, and its own regulations. Consolidation will streamline Government by eliminating this overlap.

We estimate that the administrative cost savings to the Government from agency consolidation will run somewhere between $150 and $200 million a year, after initial transition costs and even apart from any fundamental changes in the examination process. Direct savings to the banking industry will be substantially greater. Banks will be able to turn from form-filing to lending, as they will have only one regulator to deal with instead of two, three, or four, and only one set of examinations and compliance reports to complete instead of many. Current trends in the financial services industry make the reduction of compliance costs imperative. Competition from other providers of financial services is shrinking profit margins in banking, making it increasingly important for banks and thrifts to minimize expenses.

In 1992, the Federal Financial Institutions Examination Council, chaired by Governor John LaWare of the Federal Reserve Board, estimated that the cost of comply-

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[12] Peterson, "Conflicts Between Monetary Policy and Bank Supervision," 1 *Issues in Bank Regulation*, 25, 26 (1977).

[13] Remarks of J.L. Robertson Before the 72nd Annual Convention of the Tennessee Bankers Association (May 16, 1962), as reprinted in *Federal Bank Commission Act, Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs*, 94th Cong., 1st Sess., 20 (1975). Federal Reserve Board Vice Chairman Robertson further stated that, "[t]he overriding reason . . . for seeking to have supervisory powers vested elsewhere than the Federal Reserve is my deep-seated conviction that bank examiners should always be free to call the pitches as they see them. They should be insulated from any possible temptation of the monetary authority to use supervisory powers to implement monetary policy. . . ." Robertson, "Federal Regulation of Banking: A Plea for Unification," 31 *Law & Contemp. Probs.* 673, 692 (1966).

[14] The FHLBB was replaced by the OTS in 1989.

ing with banking regulations may be as high as 14 percent of banks' non-interest expenses. Given bank and thrift non-interest expenses of $156 billion in 1992, that means the cost of complying with banking regulations may be as high as $22 billion annually. These costs are passed on—in one way or another—to customers.

If the Administration's reorganization proposal reduces this burden by *only 5 percent*, it will result in savings of over $1 billion per year to the industry. These are cost savings that eventually can be translated into loans to businesses and homeowners and benefits to consumers.

F. A Single Regulator Will Be Responsive to the Concerns of Community Banks

Since a large proportion of the Nation's banking assets are held by a relatively small number of banking institutions, small banks, particularly State-chartered banks, have expressed concern that a single Federal regulator would concentrate on the issues important to large banks. I believe the Federal Banking Commission will actually be more responsive to concerns of small institutions than the present regulatory regime.

The FBC will be dedicated to bank supervision. In the present system, most small banks are regulated by either the Federal Reserve or the FDIC, both of which have other, potentially conflicting, and at least distracting, core functions. Under the Consolidation Act, the FBC will focus solely on bank supervision and not have any conflicting responsibilities. As a result, small banks will have a regulator that is solely dedicated to responding to supervisory concerns.

The FBC will supervise banks in all 50 States and the District of Columbia. As the sole agency accountable for banking matters, it will have to be responsive to concerns of the full range of banks and thrifts—otherwise, I am sure the FBC will hear from the Members of this Committee and the rest of Congress.

G. A Consolidated Agency Will Assess Fees and Expenses Equitably Among Institutions

Like the OCC, OTS, and FDIC, the FBC will not require any taxpayer funds. It will recover all its costs through non-appropriated means. The Administration's proposal incorporates a funding method for the FBC that is equitable to both national and State banks and institutions of all sizes.

The current funding system is based largely on assessments levied on institutions to pay for the cost of their supervision and regulation. The current system, however, does not always allocate the costs fairly.

All institutions currently pay for FDIC supervision through deposit insurance premiums. A rough estimate is that approximately 1 basis point of the deposit insurance charge currently goes for FDIC supervision expenses. But because the FDIC directly supervises only State non-member banks, national and State member banks bear far more than their fair share of the FDIC's examination costs.

Holding companies and State member banks are inspected without charge by the Federal Reserve. Taxpayers pay indirectly for these costs, which the Administration recently estimated at about $311 million annually, since this amount represents monies that are not turned over to the Treasury by the Federal Reserve.

National banks and thrifts pay assessments to the OCC and OTS to cover the costs of their examinations. State banks pay varying amounts to their State regulators, but these charges are typically less than Federal assessments.

Under the Consolidation Act, the FBC will be funded from three sources. The FDIC will earmark a small portion—1 basis point—of the deposit insurance premiums that it collects from all depository institutions to pay for Federal supervision—essentially the same amount it uses for supervision today—but the money would be provided to the FBC. Deposit insurance premiums would not rise; indeed, they are projected to fall sharply, as the Bank Insurance Fund approaches its statutory target of 1.25 percent of reserves to insured deposits. We anticipate, in fact, that with the likely decrease in deposit insurance premiums for banks, the combined deposit insurance premium and supervision charge will be less than the insurance premium banks pay today.

For a transition period, the Federal Reserve will make annual payments to the FBC in an amount equal to the Federal Reserve's savings from transferring supervisory functions to the FBC. This payment would begin to phase out in the sixth year after consolidation and would be fully phased out after the fourteenth year.

The rest of the FBC's funds will be generated by fees levied on the institutions it examines. Assessments would be based on asset size. National banks and thrifts will pay fees on the full amount of their assets. State-chartered banks will pay no fees on their first $1 billion in assets, and fees on assets of more than $1 billion will be at no more than half of the rate for national banks of comparable size.

All assessments will be set pursuant to standard notice and comment procedures to solicit industry input, and, along with all FBC expenditures, will be subject to periodic review by the General Accounting Office, Congress, and FBC board members.

V. Response to Concerns About the Administration's Proposal

Change is always unsettling, even change for the better. We all know this is particularly true in Washington, when responsibilities are proposed to be shifted from one bureaucracy to another. Critics of the Administration's proposal, which include certain members of the Federal Reserve, have raised a number of concerns respecting those aspects of the Consolidation Act that will reduce the Federal Reserve's bank supervisory and regulatory functions. In fact, the Federal Reserve Board has even published a counterproposal. But virtually everyone agrees that consolidation of some form is needed.

The arguments opposing the Administration's plan all assert that the Federal Reserve must retain a large role in banking regulation and supervision. Several of these arguments rely on intimidating invocations of terms such as "systemic risk," or the "payments system." When probed, however, none of the arguments are persuasive. We have carefully crafted the Administration's proposal to take account of the Federal Reserve's legitimate needs and concerns.

A. ONE FEDERAL REGULATOR IS BETTER THAN TWO

Critics contend that we need more than one Federal banking agency in order to promote "competition" in the bank regulation and supervision arenas and to preserve "the healthy process of dynamic tension in bank rulemaking." This argument sounds very strange to me. Its logic would require any really important Federal regulatory responsibility to be split between at least two agencies. Thus, we should have two Securities and Exchange Commissions, or three Food and Drug Administrations. Fortunately for the taxpayers, the Federal Government is not Noah's Ark—two of everything is not necessary, or sensible.

The argument for maintaining multiple banking regulators also fails as a practical matter. To the extent multiple regulators have different viewpoints, banking organizations can express their regulatory preferences by switching their charters so they come under the jurisdiction of their preferred regulator. However, it is difficult to see any advantage or reason to continue or encourage this type of regulatory arbitrage. The more lenient regulator always wins, whether or not its views best promote safety and soundness or other public policy goals such as fair lending.

It also is a mistake to believe competition among bank agencies is needed to promote financial product innovation. Innovation is not initiated by bank regulatory agencies. It comes from the marketplace, not a Government desk. It is the nonbank financial services providers, which dominate the industry, as well as foreign banks, that now instigate change by responding to and anticipating customer needs. State banking industries also serve as testing grounds for new ideas.

Some critics further argue against full consolidation on the grounds that it would eliminate important checks and balances on supervisory powers. This argument is predicated upon a fundamental misunderstanding of what governmental checks and balances are all about. Regulatory power is not restrained by creating additional agencies to perform duplicate functions. Rather, an agency acts responsibly because it is subject to congressional oversight, the courts, the press, and market pressures—particularly from the nonbank financial services sector and foreign bank regulators. National banks and thrifts also will retain their ability to convert to State charters in order to switch their primary regulator.

Moreover, as mentioned above, the FBC will be governed by a five member board that will include a representative of the Federal Reserve. The Consolidation Act also will require a political mix on the FBC board. This diverse governing body will not be of one mind on every issue and to suggest that Commission members will not express their views when they disagree with each other is to say that FBC members will behave differently from members of every other Government commission and board. In addition, the FDIC will retain authority to conduct backup examinations when it deems necessary. The staff of the Federal Reserve will participate in FBC bank examinations, communicate freely with FBC examiners, and take backup enforcement action when needed. In other words, the structure of the FBC, and its relationship with the FDIC and the Federal Reserve, will provide plenty of balance.

B. THE ADMINISTRATION'S PROPOSAL PROVIDES AN APPROPRIATE ROLE FOR THE FEDERAL RESERVE

I know each of you have heard voices saying that the Administration's proposal would improvidently remove the Federal Reserve from the bank supervisory busi-

ness which, in turn, would cause untold harm to our economic system and increase the risk of systemic financial crises. This is not true.

The Federal Reserve, and others, have articulated a number of needs—this consolidation proposal meets those needs. The Federal Reserve is concerned about its access to the bank supervisory process, which it believes it needs to conduct monetary policy and control systemic risk. It also has sought assurances that it will retain the powers necessary to manage the discount window and payments system. This proposal satisfies all of these concerns, providing the Federal Reserve with sufficient bank supervisory capabilities and preserving all of its core, central bank powers and responsibilities. Let me assure you, this Administration would do nothing to put any part of our financial system in jeopardy.

1. *The Federal Reserve Will Have Ample Bank Supervisory Powers to Perform its Central Bank Functions*

Opponents of full consolidation argue that the integrity of our monetary policy and the stability of the financial system depend on the Federal Reserve maintaining a role in banking supervision. The Administration's proposal fully addresses this concern and actually *expands* the scope of the Federal Reserve's supervisory authority in banks most related to these functions.

Today, the Federal Reserve directly supervises only 7 percent of all FDIC-insured depository institutions, and only 15 percent of the Nation's bank and thrift assets. Most of the banks under its supervision are small, with an average size of less than $45 million in assets. The Federal Reserve supervises only 12 of the 52 U.S. banks with assets of more than $10 billion, and only 5 of the 20 largest institutions. For information concerning the remaining 93 percent of the depository institutions, including most of the largest organizations, the Federal Reserve relies on reports prepared by the other banking agencies—namely the OCC, OTS, and FDIC.

Some contend that it is unrealistic and unduly hopeful to believe that the knowledge and expertise that the Federal Reserve needs to do its job properly can be gained from studying exam reports prepared by another agency. However, this is exactly what the Federal Reserve does today. Review of Federal Reserve supervisory practices at the largest national bank holding companies reveals that the Federal Reserve relies heavily, indeed, almost entirely, on the examination reports prepared by the OCC for information regarding national banks and their subsidiaries. The Federal Reserve does not audit, or otherwise probe behind the conclusions of the OCC reports. The OCC's conclusions regarding the national banks are adopted wholesale and often incorporated into the Federal Reserve's annual bank holding company reports. If the Federal Reserve can rely on the examination reports prepared by the OCC and the other Federal banking agencies for the bulk of the information it obtains regarding the banking industry, it is hard to see why it cannot rely on the more comprehensive reports that will be prepared by the FBC.[15] The contention that sound monetary policy rests on the Federal Reserve's continued direct supervision over a small subset of the banking industry simply is not credible.[16]

Moreover, much of the Federal Reserve's supervisory activities in connection with bank holding companies with national bank subsidiaries are duplicative of the work already performed by the OCC and the States. This duplication results from the way modern banking organizations are structured and operated, and the different supervisory approaches taken by the Federal Reserve and the OCC.

Most banking organizations are structured along functional lines rather than according to charter type. For example, a banking organization may engage in securities trading through its bank and nonbank subsidiaries. Since the activities of these

[15] In addition to receiving FBC examination reports, the Administration's proposal will enable the Federal Reserve to participate actively in FBC examinations of key institutions. Considering that the Federal Reserve currently examines only 6 of the Nation's 25 largest banks, the Consolidation Act will significantly expand the Federal Reserve's information-gathering capacity. The Federal Reserve will also have a representative on the FBC board, and will be able to consult with FBC examiners, many of whom will undoubtedly be drawn from the Federal Reserve's present bank examiner ranks. It will be unlawful for the FBC to withhold information, at any level, from the Federal Reserve.

[16] Even if the Federal Reserve's powers were expanded to include responsibility for all bank supervision, it could not obtain, by itself, the information necessary to formulate monetary policy. Banks hold only 36 percent of the Nation's credit market assets. Relying solely upon banks to take the pulse of the financial services sector is an anachronism that the Federal Reserve had to abandon long ago as the market shares of nonbank competitors have grown. In addition, sound monetary policy depends on information from the non-financial sectors of the economy and the Federal Reserve obtains most of this information from others—such as the Departments of Commerce and Labor. While it supplements this data with its own surveys, the Federal Reserve does not take the position that it needs to duplicate the data-gathering operations of the other agencies. It can work the same way for the banking sector.

various entities often are highly integrated, a proper examination of most modern banking organizations must encompass the bank's interactions with its nonbank affiliates, not just banking operations or nonbanking operations taken in isolation. For this reason, the OCC looks at the holding company nonbank subsidiaries in connection with its examination of national banks. The Federal Reserve frequently repeats part of the process, however, when it looks at the same subsidiaries in connection with its inspection of holding company nonbanking entities.

Similarly, since the procedures and controls of the banking and nonbanking subsidiaries often are the same, it is not necessary to examine them twice—first for the bank subsidiaries and then for the nonbank subsidiaries. Nonetheless, under the current system, this is exactly what happens. The OCC examines the procedures and controls of the national bank subsidiaries and the Federal Reserve inspects the same procedures and controls in connection with its review of the holding company's nonbank subsidiaries.

The Administration's plan satisfies the needs articulated by the Federal Reserve for a significant supervisory role and, at the same time, dramatically reduces the duplication and eliminates the inconsistency inherent in the current supervisory system. By allowing the Federal Reserve to participate in, and even direct, joint examinations, the Consolidation Act will give the Federal Reserve a "hands-on" role involving up to 30 percent of the Nation's bank and thrift assets—double the amount under its present direct supervision.[17]

I do not accept the assertion that the changes proposed to the Federal Reserve's bank regulatory responsibilities and the redefinition of its bank supervisory authority will so reduce the Federal Reserve's "clout" that it will become incapable of implementing monetary policy. While any reform of the banking system must inevitably shift responsibilities, the Federal Reserve will lose only a fraction of its powers and responsibilities and will gain others. It will retain all of its core functions and powers, including the formation of monetary policy, open market operations, establishment of bank reserve requirements, management of the payments system, and operation of the discount window. It will only lose its rulemaking authority over State member banks and bank holding companies. Given that all State member banks hold only 15 percent of the Nation's bank and thrift assets, it is difficult to see how the Federal Reserve could be rendered ineffectual by the loss of direct control over these institutions. No banker would ever ignore the local Federal Reserve district bank President, let alone the Federal Reserve Board in Washington.

2. *The Federal Reserve Will Retain Full Authority to Manage the Payments System and Operate the Discount Window*

Under the Consolidation Act, the Federal Reserve will continue to have complete, independent authority to regulate and supervise the payments system. Notwithstanding, certain critics oppose agency consolidation on the basis that it could impair the Federal Reserve's ability to manage the payments system. Few challenge this argument because few understand what the "payments system" is, or what the Federal Reserve does in connection with it. Let us look at what is really going on.

The Federal Reserve basically performs four different functions in relation to the payments system. First, it is responsible for insuring sufficient currency is in circulation. When depository institutions need more currency, such as during the holiday shopping season, they can order currency from the Federal Reserve Banks and branches. These banks and branches also retire currency when the need for cash

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[17] It is worth noting that some contend the Federal Reserve does not need any "hands-on" supervisory experience to monitor the Nation's economy. At present, the Federal Reserve's monetary policymakers do not conduct bank examinations nor do they sit down with Federal Reserve bank examiners and discuss the conditions of particular banks. They get the banking information they need to formulate monetary policy from examination reports. "Divorcing the Federal Reserve from bank supervision would in no way diminish its ability to keep abreast of banking developments . . . [and] would enable the Federal Reserve Board to devote its time and attention exclusively to its most valued function—the formulation and implementation of monetary policy." Federal Reserve Board Vice Chairman Robertson *supra* note 13, at 692.

The experiences of other countries' central banks do not support the contention that effective monetary policy requires direct bank supervisory authority. While comparisons of the bank regulatory and monetary policy apparatus in other countries is difficult, the diversity of systems certainly indicates that there is no "right" way to accomplish these tasks. Only four of the twelve Basle Committee countries conduct banking regulation and supervision mainly through their central bank. Even in those cases—and in many of the other countries where banking regulation has been lodged in the central bank—the bank itself is responsible to or overseen by a government entity, typically the Finance Ministry. The United States is unique among developed countries in having *both* fully insulated its central bank from ongoing national executive control *and* having assigned it a major role in bank regulation and supervision. For a more detailed discussion of the role of other central banks in bank regulation and supervision, see Appendix C.

declines and depository institutions return excess currency in exchange for credit to their accounts. Thus, for these purposes, the Federal Reserve serves as a cashier. It does not need to supervise banks or their holding companies to perform this function.

The second component of the Federal Reserve's role in the payments system concerns check-processing services. The Federal Reserve has complete authority to regulate all aspects of the check-processing system, including the receipt, payment, collection, and clearing of checks. Its authority in this regard is complete. This, too, requires no further regulatory powers over banks.

It is important to note that the Federal Reserve competes with private check clearing services in the processing of checks. Clearing centers process checks by crediting the accounts of institutions receiving payments, and debiting the accounts of paying institutions. The success of these competitors is further evidence that the Federal Reserve does not need bank supervisory powers to perform these check-processing services.

The third Federal Reserve function in the payments system involves electronic funds transfer services. Federal Reserve offices transfer large dollar payments between different institutions, or an institution and the U.S. Treasury or other Government agency, through the "Fedwire" system. Such transfers take only a few minutes and are guaranteed final once the receiving institution receives notice of a credit to its account. Fedwire competes with other electronic fund transfer services, such as the Clearing House Interbank Payments System ("CHIPS") and the Society for Worldwide Interbank Financial Telecommunications ("SWIFT"). As with check clearing centers, the existence of private electronic fund transfer services, like CHIPS and SWIFT, demonstrates that there is no essential link between bank supervision and operation of the Fedwire system.

The final role of the Federal Reserve in the payments system concerns its net settlement services. The Federal Reserve Banks provide these services to private participants in the payments system (*e.g.*, check clearinghouses and wire transfer systems) that process a large volume of transactions among their member institutions. The Federal Reserve Banks perform net settlement by posting net debit and net credit entries generated by these private organizations to the accounts of individual institutions. Essentially, this is an extensive, sophisticated computer system that keeps track of the flow of funds between institutions. This function, too, does not depend on any bank supervisory powers the Federal Reserve may or may not have.

The Federal Reserve does not need bank supervisory powers in order to perform any of its responsibilities in connection with the payments system. This is obvious, since today the Federal Reserve directly supervises only 15 percent of the Nation's bank and thrift assets and only approximately 970 out of 13,500 depository institutions. No evidence suggests that the Federal Reserve conducts any "hands-on" supervisory examination of individual banking institutions not under its primary supervision in regards to the payments system.

Some also have asked whether the Federal Reserve needs bank supervisory powers to operate the "discount window." Like the Federal Reserve's oversight of the payments system, its management of the discount window (where Federal Reserve Banks make short-term, secured loans to financial institutions), does not depend upon the Federal Reserve's bank supervisory jurisdiction. As noted above, the Federal Reserve does not examine the vast majority of institutions that borrow from the discount window, and no evidence indicates the Federal Reserve conducts any "hands-on" supervision of individual institutions with respect to their use of the discount window. Under the Consolidation Act, the Federal Reserve will coordinate with FBC regulators to assess the financial condition of all banks, much as it coordinates with the OCC, OTS, and FDIC today. Moreover, the Federal Reserve lends only on a fully secured basis, and traditionally, accepts only the highest quality collateral, *e.g.*, Government securities. It does not take knowledge about banking to evaluate the quality of readily marketable Government securities. And it does not take the skills of an entire bank examination agency to be a fully-secured lender.

3. *The Federal Reserve Will Have Abundant Bank Supervisory Powers to Guard Against "Systemic Risk"*

The term "systemic risk" pops up in virtually every statement made by opponents of the Administration's consolidation proposal. Like the "payments system," few understand what systemic risk is, and fewer still know the Federal Reserve's connection with it.

Systemic risk refers to the likelihood of a sudden, unexpected, and widespread collapse of confidence in the financial system, with a potentially large effect on the economy in general. Systemic risk can be triggered by a wide variety of events and originate either inside or outside the banking system. One recent example of a sys-

temic event occurred in October 1987, when the Dow Jones stock market index dropped almost 600 points in a single day.[18] What made this a potential "systemic" crisis was the possibility of contagion, or other spill-over effect. Virtually every aspect of the financial system was affected by the 1987 stock market break. This system includes banks and thrifts, insurance companies, investment banks, finance companies, pension funds, mutual funds, and various Government sponsored agencies, as well as the markets where financial instruments trade, such as the stock markets, markets for public and private debt, futures exchanges, international markets, and over-the-counter markets.

Consolidation opponents try to raise the specter of impending financial crisis by stating that any reduction in the Federal Reserve's banking regulatory responsibilities would decrease its ability to anticipate and cope with potential systemic financial problems. This is simply not correct.

The financial market encompasses far more than the State-chartered member banks that the Federal Reserve directly supervises today. As previously noted, it includes stock markets, bond markets, commodities markets, the insurance industry, and many other components. Today, the Federal Reserve is the principal supervisory authority for only a small fraction of the overall market. The SEC, OTS, OCC, FDIC, Department of the Treasury, and additional Federal agencies, together with State bank and insurance regulators and the supervisory authorities in other countries, are all responsible for overseeing portions of this market.[19] The Federal Reserve does not have, and has not argued that it needs or wants supervisory authority over these other institutions or markets to deal with systemic risk. Recent events suggest that this arrangement works well. Thus, it appears that the Federal Reserve is satisfied that these other supervisory authorities and the information they collect and supply are sufficient for it to contain systemic risk. It is difficult to understand why the Federal Reserve would be unable to cooperate with the FBC to obtain whatever information it needs about the banking industry.

The consolidation proposal also will not affect the Federal Reserve's ability to react to a systemic shock. The Federal Reserve responds to systemic crises by supplying liquidity through open market operations, discount window lending, or some combination of the two. In the case of open market operations, the Federal Reserve relies on the market to allocate the new liquidity. No Federal Reserve bank supervisory capability is required. The effectiveness of this approach has been demonstrated in a number of recent cases, such as the failure of Drexel Burnham Lambert in 1990 and the stock market break in 1987.

Not every financial market disturbance constitutes a systemic risk. In fact, in the post-Depression era, truly systemic events have been relatively rare. Furthermore, the possession of bank supervisory capabilities would not likely help the Federal Reserve to anticipate the type of market shocks that trigger systemic events, such as extreme stock or commodity price movements or regional recessions. In any event, as discussed above, the Federal Reserve will continue to have significant bank supervisory powers under the Administration's plan.

No one wishes to impair the means for dealing with a systemic crisis. But the Administration's proposal raises no such issue. The Consolidation Act does not reduce the Federal Reserve's ability to monitor and anticipate systemic risk nor to react to a systemic problem and play its role along with other agencies.

VI. Conclusion

The need to restructure the Federal banking and thrift regulatory system has grown more urgent over the past several decades, as distinctions among depository institutions have blurred and the regulatory system has grown more costly and complex, and less efficient and responsible. In this time of economic stability, when bank profits remain at all-time highs, we have an opportunity to take bold, comprehensive action to improve the system.

Reforming our Nation's regulatory structure is one of the most significant steps that could be taken to reduce the regulatory burdens on insured depository institu-

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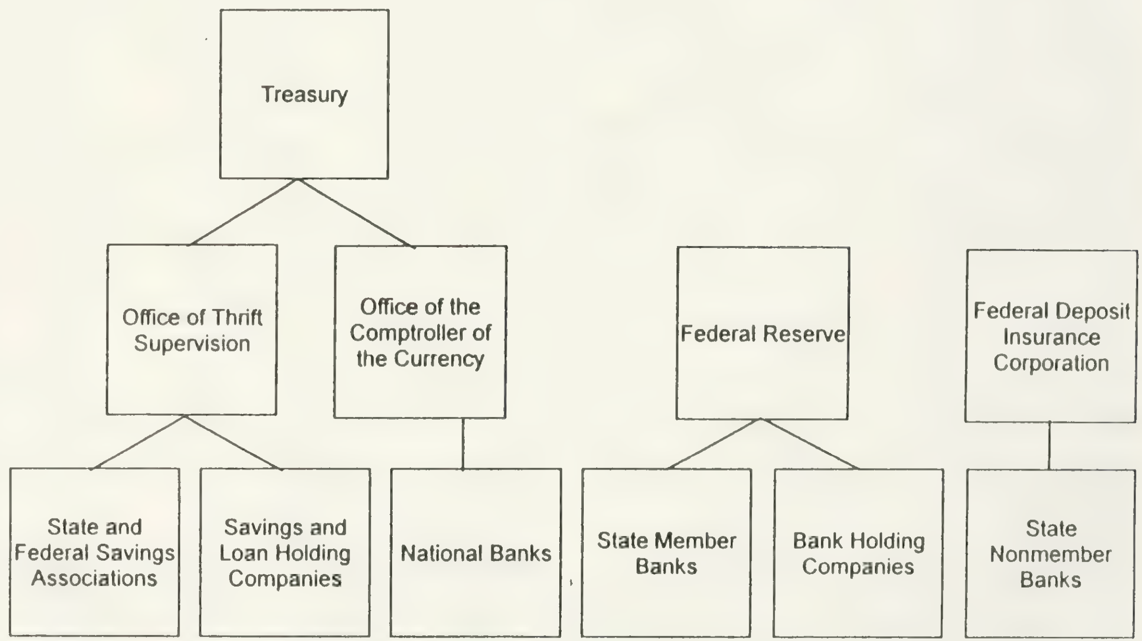
[18] The failure of Drexel Burnham Lambert in 1990 arguably constituted a systemic crisis, albeit a much less significant event than the 1987 stock market drop.

[19] The Federal Reserve is by no means the only agency involved in crisis management. Other Government agencies can and do play a role in containing systemic problems. For example, by virtue of the deposit guarantee it conveys, the FDIC bolsters public confidence in the banking system's ability to pay insured depositors. The OCC contains systemic risk when it removes uncertainty in financial markets by quickly, consistently, and uniformly dealing with troubled and failing national banks. The Working Group on Financial Markets, comprised of representatives from the Treasury Department, the Federal Reserve, the SEC, and the Commodities Futures Trading Commission, also monitors financial market activities and addresses systemic risk issues.

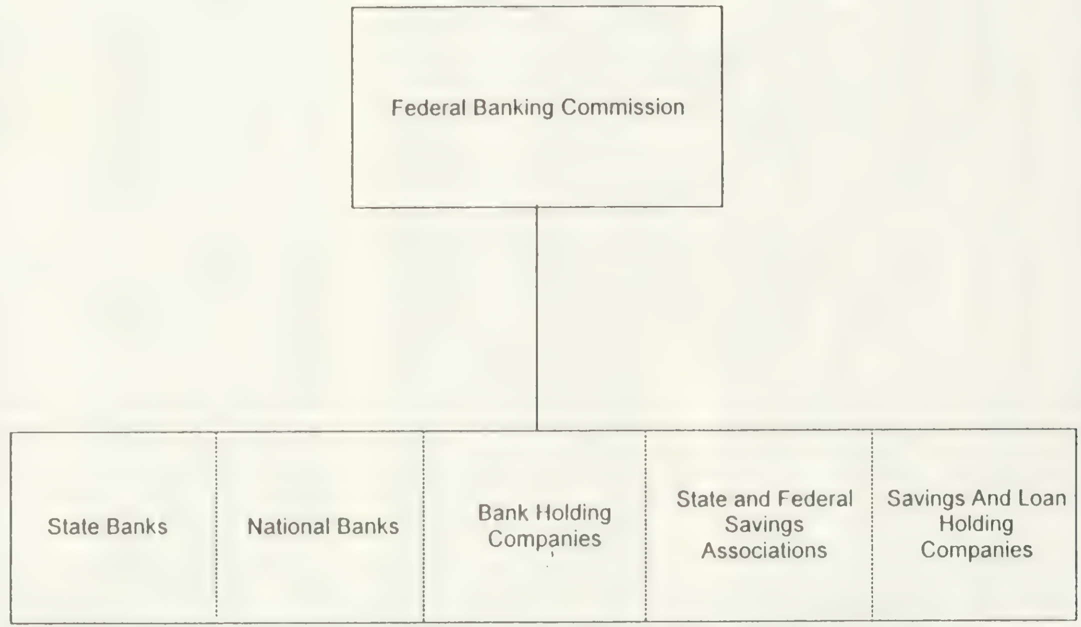
tions and help assure their continued success. The Administration's proposal is the best way to accomplish this reform. It will allow banking institutions to compete more effectively and it will promote better service to consumers. It will create a regulatory structure that is more effective than the current hodgepodge of agencies in overseeing the safety and soundness of individual banking organizations and safeguarding the stability of the banking system as a whole. The Consolidation Act also will advance the overall agenda of reinventing Government by streamlining the bureaucracy, reducing costs, and improving service. For all these reasons I urge this Committee and the Congress to move quickly on the Consolidation Act, and I, the rest of the Treasury Department, and other Members of the Administration, look forward to working with you.

That completes my formal statement. I would be pleased to answer any questions you have.

Appendix A: The Current Federal Structure for Supervising FDIC-Insured Depository Institutions and Their Holding Companies



Appendix B: The Proposed Federal Structure for Supervising FDIC-Insured Depository Institutions and Their Holding Companies



Appendix C: Bank Supervision Responsibilities in the Non-U.S. Member Countries of the Basle Committee on Banking Supervision

Belgium

Bank supervision is the responsibility of the Banking and Finance Commission, an autonomous commission.

Monetary policy is the responsibility of the National Bank of Belgium, the central bank.

Canada

Bank supervision is the responsibility of an independent agency, the Office of the Superintendent of Financial Institutions (OSFI). The Superintendent is appointed by the Finance Minister and confirmed by the Cabinet for a 7-year term. Governmental policy regarding financial institutions is determined by the Finance Department.

Monetary policy is the responsibility of the central bank, the Bank of Canada. The Prime Minister appoints the Bank's Board of Directors, which selects the Governor. The Governor is confirmed by the Cabinet and serves a 7-year term which does not coincide with that of the government.

France

Bank supervision is the responsibility of the Banking Commission, which is chaired by the Governor of the Bank of France (central bank) and includes a high ranking Finance Ministry official as Vice Chairman. At present, the Banking Commission's staff is drawn from the Bank of France, although 1993 legislation gives the Commission authority to recruit from other sources as well. Overall regulatory policy is established by the Committee for Banking Regulation, which is chaired by the Finance Minister. The 1993 legislation strengthening the central bank's independence also *deleted* the designation of the Governor of the Bank of France as Vice Chairman (although continuing the Governor as a Committee member).

Under the recent legislation, monetary policy is now the responsibility of the Bank of France, which must aim to assure price stability "within the government's general economic policy framework." A nine-member Monetary Policy Council (with six independent members named by the government) makes the necessary decisions; the Finance Minister may participate in the Council's meetings but not in its decisions.

Germany

Bank supervision is the responsibility of the Federal Banking Supervisory Office (FBSO), an agency of the Finance Ministry. The FBSO is headed by a President, who is nominated by the German Chancellor and appointed for an unspecified term by the German President. Certain regulatory changes proposed by the FBSO must have the concurrence of the central bank (Bundesbank). The FBSO also depends in part on the central bank for data collection and monitoring of compliance with banking regulations (e.g., foreign exchange).

Monetary policy is the responsibility of the Bundesbank, the central bank, with sole authority to formulate and implement monetary policy. The President of the Bundesbank is nominated by the German Chancellor and appointed by the German President for an 8-year term, which does not coincide with the term of the government.

Italy

Bank supervision is the responsibility of the Bank of Italy. The Bank of Italy is a public institution whose shareholders are public financial institutions. The Governor is appointed for an unspecified term, generally for life, by the Bank's Senior Council, whose members are nominated by the shareholders. The Prime Minister and the Treasury Minister must approve the nomination of the Governor. The Treasury Ministry has the responsibility for inspecting the Bank of Italy.

Monetary policy is the responsibility of the Bank of Italy. The Bank sets the monetary and credit targets and official interest rates within the guidelines of the Inter-Ministerial Economic Planning Committee (CIPE). CIPE is chaired by the Prime Minister and includes Ministers of the Treasury, Budget, and Finance. CIPE sets macroeconomic policy such as GDP growth and inflation targets.

Japan

Responsibility for bank supervision is shared by the Ministry of Finance (MOF) and the Bank of Japan. Licensing, regulation, and supervision are the direct, primary responsibility of the Ministry of Finance. The MOF Banking Bureau plays the most significant role, although the International Finance Bureau of the MOF super-

vises bank's foreign exchange and international operations. Banks are also supervised to some degree by the Bank of Japan, which has entered into broad supervisory agreements with all individual banks and many other financial institutions as a condition of access to bank credit services and payment facilities.

Monetary policy is the responsibility of the Bank of Japan. While nominally independent, Bank of Japan policy is heavily influenced by the MOF, which has a nonvoting seat on its board. The Governor of the Bank of Japan is appointed for a 5-year term by the Cabinet, reflecting the consensus of the Prime Minister and the leadership of the ruling party. His term does not coincide with that of the government.

Luxembourg

Bank supervision is the responsibility of the Institut Monetaire Luxembourgeois, which is an autonomous authority; however, some staff members of the Institut are appointed by the Ministry of International Finance, which also has some involvement in bank supervision matters.

Luxembourg's monetary policy is the responsibility of the Ministry of International Finance, which works closely with the Belgian Ministry of Finance and the Belgian Central Bank. Luxembourg has no central bank.

Netherlands

The central bank, De Nederlandsche Bank, is responsible for both the supervision of the banking system and monetary policy. The management of the Bank is overseen by a Governing Board, consisting of a President, a Secretary, and four other members, who are appointed by the Minister of Finance for a period of 7 years. The government exerts its influence over the Bank's administration through its Supervisory Board, which consists of twelve members, all appointed by the Ministry of Finance.

Sweden

The Financial Supervisory Authority, which is subordinate to the Ministry of Finance, is responsible for the licensing and supervision of banks (and insurance, securities, and other credit companies). The authority is directed by a Board comprised of six government-appointed members and a Director-General, who serves as Chairman.

The Sveriges Riksbank, the central bank, is responsible for monetary policy. The Bank is independent of the government, reporting to the Swedish parliament.

Switzerland

Bank supervision is the responsibility of the independent Federal Banking Commission. The Commission members, including the President, are appointed by the Cabinet of the Executive Branch (Federal Council) for 4-year terms. The President can be reappointed. The Commission works part-time, and its work is carried out by a secretariat administratively under the Finance Ministry.

Monetary policy is the responsibility of the independent central bank, the Swiss National Bank. The Bank's Governing Board meets periodically with the government to coordinate major policy decisions. The President of the Governing Board is nominated by the private sector National Bank Council and appointed to a 6-year term by the Federal Council.

United Kingdom

H.M. Treasury is responsible for establishing the overall legislative framework for the operation and implementation of all facets of the financial services sector, including banking, securities, and building societies. In addition, H.M. Treasury is responsible for establishing monetary policy. Meanwhile, the Bank of England plays a role in implementing monetary policy and supervises the banking industry. Responsibility for supervising the securities industry rests with the Securities and Investments Board and/or one of the recognized Self-Regulatory Organizations.

Bank supervision is the responsibility of the Bank of England (central bank). The Governor is appointed by the Prime Minister for a 5-year term that does not coincide with that of the government.

Monetary policy is the responsibility of the Treasury. Decisions to change the base interest rate are made by the Chancellor of the Exchequer (Finance Minister) in consultation with the Prime Minister and with the advice of the Governor of the Bank of England. The Bank of England carries out monetary policy for the government.

Primary Responsibility for Bank Supervision and Monetary Policy in Non-U.S. Member Countries of the Basle Committee on Banking Supervision

	FINANCE MINISTRY	CENTRAL BANK*	OTHER
Bank Supervision	Germany (a) Luxembourg Japan (a) Sweden	France (b) Italy Netherlands United Kingdom	Belgium (c) Canada (c) Switzerland (c)
Monetary Policy	Luxembourg United Kingdom	France Belgium Canada Germany Japan Netherlands Sweden Switzerland	Italy (Committee)

(a) Some involvement of Central Bank
(b) Significant involvement of Ministry of Finance
(c) Independent Authorities

*In no case is bank supervision the responsibility of an independent central bank.

THE WORTHEN STORY

Worthen Banking Corporation is the largest bank holding company in Arkansas. It has a history of run-ins with the Federal Reserve and is currently under investigation by the Fed for potential insider-dealing.

Worthen is notable for several reasons.

Worthen Bank came to President Clinton's rescue with a $3.5 million line of credit when his campaign was running out of funds after Super Tuesday. That's $3.5 million in an emergency, not a $10,000 PAC contribution or a $100,000 donation to the DNC.

Worthen apparently was seeking a greater voice in Washington. Before November election, its chairman said, "I would like to be in a position to think I could call the President of the United States and give him my views on the Federal Reserve, for example."

Why single out the Federal Reserve?

The Federal Reserve required Worthen to enter into a consent agreement in 1986 over Worthen's financial condition. Now the Fed is investigating insider-dealing at Worthen.

Under the Administration's proposal, the Federal Reserve would be stripped of regulatory oversight over Worthen Banking Corporation.

At a time when a special prosecutor is investigating the ties between politics and banking in Arkansas, I'm concerned about an Administration proposal to increase the politization of federal regulation, especially when its friends in Arkansas stand to benefit.

SUMMARY OF WORTHEN

•Worthen Banking Corp is the largest bank holding company in Arkansas with asset value of $3.8 billion. They serve 40 communities at 101 locations through a state-network of 10 community banks. They are also very active players in Arkansas politics, and their largest stockholder is the Stephens family, who owns 38% of the stock.

•Jack Stephens personal line of credit (of $5 million) at Worthen Bank is generally a quarter point below prime. (WSJ 10/12/92)

•Systematics Inc. a Stephens founded data processing firm ("founder" Walter Smiley listed as Clinton top 100 supporter, close to Mack McLarty (according to Arkansas Business Journal) has been paid more than $30 million over the past decade by Worthen;

•Stephens Link, a computer program linking up a person with the services of Stephens Inc, can be accessed from the Worthen Bank lobby in order to open an account with the investment firm; (WSJ 10/12/92)

•Hollis & Co.(owned by the Stephens family) was an industrial equipment firm that sold equipment to Arkla Inc. (a publicly held natural gas utility) who was headed by Witt Stephens. In the mid-80's a management shift occurred and Arkla began putting this contract out for competitive bid, costing Hollis business. This led to the family putting the business up for sale. A potential buyer went to Worthen to finance the purchase, but were turned down. According to court records, one of the members of the purchasing group went to Jack Stephens, who according to the deposition told an aide to "take care of that". The $4 million loan was approved the next day. Unfortunately for Worthen, but fortunately for Stephens, the company went bankrupt not long after the purchase -- and in fact the bankruptcy trustee has stated that the company was bankrupt when Worthen financed the loan. (WSJ 10/12/92)

•In 1987, the comptroller of the currency gave Worthen a slap on the wrist for self-dealing practices, but nothing was done to the Stephens empire.

•According to the WSJ, because of a shareholder lawsuit, Worthen was required to get a discount from Stephens Inc. investment in order to keep using the firm (this was reported on 10/12/92)

•On March 20, 1992 Worthen announced the signing of a definitive agreement to acquire Stephens Diversified Leasing, subject to regulatory approval. In a December 4th Business Wire story it was noted that they continue to seek that approval, and have a tentative schedule for the shareholders meeting on January 15th.

•At some point in 1992 the St. Louis Federal Reserve began an investigation of Worthen and its expansion plans, this report is what led to a formal investigation by the Washington Fed office of possible Glass-Steagal violations in connection with the Stephens family ownership of a small bank in Stuttgart Arkansas (the Stephans family owned about 38% of Worthen's stock) (NYT 5/31/93).

•Another class action shareholder lawsuit was filed on January 11, 1993 regarding the proposed acquisition of Stephens Diversified Leasing Inc. (which is primarily owned by the Stephens family). The suit was settled out of court and a memorandum of understanding was drafted up requiring full disclosure of the terms and conditions; delaying vote by stockholders on the purchase until after the details are known; and a requirement that Worthen's investment advisor issue an opinion that the terms of the acquisition are fair to Worthen from a financial standpoint. In addition, Worthen agreed to pay the plaintiffs legal fees up to the point of the settlement.

•On 4/1/93 Worthen Banking Corp president, CEO and chairman Curt Bradbury announced that the Federal Reserve is investigating the bank holding company's relationship to the Stephens family. With Worthen attempting to expand by merging with Union of Arkansas, the Fed was asked to approve the merger application. They did so according to Bradbury "in reliance upon representations and commitments made to the Board by Worthen Banking Corp, Stephens Group Inc, and Stephens family members" Bradbury also stated he believed that the Board's action predated the shareholder lawsuit over the acquisition of SDL -- which would mean late 1992. (WSJ

4/1/93)

•As reported by the WSJ on 6/23/93 the Fed investigation is continuing with meetings with Worthen officials as well as documents being turned over. They also report that a "formal investigation" was launched after the Board approved the acquisition of Union of Arkansas corp. Bradbury quoted as saying it could be a "lengthy process".

•Staff believes the investigation is on-going.

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

May 13, 1994

The Honorable Christopher Bond
United States Senate
Washington, D.C. 20510-3602

Dear Senator Bond:

During Secretary Bentsen's March 1 testimony before the Senate Banking Committee, you asked for a list of the individuals and executive branch departments or agencies involved in the interagency working group that developed the Administration's proposal to consolidate the Federal banking agencies into a new independent agency. The Treasury Department took the lead in developing the proposal. However, as is commonly the case with legislative proposals developed in the executive branch and presented as Administration bills, the ultimate proposal was an interagency effort.

In the process of developing the Administration's program, an informal interagency working group evolved. Four participants in that group, led by Secretary Bentsen, initially met with the President on October 19, 1993, to discuss a variety of banking issues, including regulatory consolidation. On November 10, 1993, the working group held the first of a series of meetings to develop the consolidation proposal.

We did not maintain a list of the individuals or agencies involved in the interagency effort, nor did we maintain a list of meetings or, in most cases, a roster of individuals attending particular meetings. Nonetheless, in response to your inquiry, we have compiled a list of the individuals and agencies involved in the interagency effort to develop the proposal.[1]

According to our reconstruction of the interagency effort, the following is a list of the individuals and agencies who were the

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[1]We have sought to reconstruct the interagency effort through calendars, notes, individuals' recollections and -- in the few available cases -- rosters of people who attended meetings. Because we did not keep a formal record of most meetings or participation in meetings, it is possible that our reconstruction may have omitted a few individuals who participated in the interagency working group. It is also possible that the extent of a few individuals' participation in the interagency effort was somewhat greater or less than that reflected in our reconstruction of the interagency effort.

most involved in the interagency process. This category includes individuals who, according to our reconstruction, attended at least three interagency meetings and also were involved in more than one issue.

Treasury Department

Main Treasury

Peter A. Bieger
Richard S. Carnell
Gordon Eastburn
David A. Lebryk
Michael B. Levy
John B. Lewis
Fé Morales Marks
Brian P. Mathis
Stephen J. McHale
Roberta K. McInerney
Frank N. Newman
Brian S. Tishuk

Office of the Comptroller of the Currency

Konrad S. Alt
John Carlson
James Kamihachi
Eugene A. Ludwig
Judith A. Walter
Julie L. Williams

Office of Thrift Supervision

William J. Durbin
Jonathan L. Fiechter
Carolyn Lieberman

Office of Management and Budget

Alice Cho
Christopher F. Edley
James J. Jukes
Peggy Kuhn
Alan Rhinesmith
Douglas Steiger

White House

Council of Economic Advisers

Constance Dunham
Joseph E. Stiglitz

National Economic Council

Ellen Seidman

Office of Legislative Affairs

Paul Carey

Additional individuals from the agencies listed above and from other agencies also participated in the interagency process that resulted in the Administration's proposed legislation.[2] The following individuals were involved in the process, but attended no more than two interagency meetings, if any, or worked only on discrete topics (such as personnel issues):

Treasury

Main Treasury

Elizabeth N. Buchbinder
Jamir R. Couch
Becky J. Ellis
Linda Oakey-Hemphill
Victor A. Rojas
MaryBeth Triano

Office of the Comptroller of the Currency

William P. Bowden, Jr.
Ronald R. Crain
Leonora S. Cross
Brenda Curry
Eileen Gallagher
Thomas D. Lantzas
Wayne Leiss
Roy C. Madsen
Gary W. Norton
Ronald P. Passero

---

[2]In addition, the following employees from the Federal Deposit Insurance Corporation attended one or two interagency meetings on personnel issues: John Chiporus, Betty Johnston, Steven A. Seelig, and Alfred P. Squerrini.

Office of Thrift Supervision

Richard Abood
William R. Casey
Walter B. Mason, Jr.
G. Jeffrey Miner
Kevin Petrasic
Dorene Rosenthal
Gail Sanders
Karen Solomon

Justice Department

David J. Anderson
Walter Dellinger
John C. Dwyer
Arthur R. Goldberg
Webster L. Hubbell
Dawn Johnson
John A. Rogovin
Michael Small
Anne L. Weisman

Office of Management and Budget

Robert Damus
Jefferson Hill
Sally Katzen
Raymond Kogut
Adrien Silas
Gary Waxman

Office of Personnel Management

Abby L. Block
Gay Gardner
John Landers

White House

Council of Economic Advisers

Alan S. Blinder
Laura D'Andrea Tyson

<u>National Economic Council</u>

Paul Dimond
Robert Rubin

<u>White House Counsel's Office</u>

Joel T. Klein

<u>Domestic Policy Council</u>

Paul Weinstein, Jr.

I hope this information is helpful to you. Please let me know if you have any questions or if you need additional information.

Sincerely,

Michael B. Levy
Assistant Secretary
(Legislative Affairs)

The Greenlining Coalition

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Fax: (415) 431-1048

EMBERS:

nerican G.I. Forum

sociation of Latino Lawyers

nter for Southeast Asian
fugee Resettlement

inese for Affirmative
tion

mision Femenil Mexicana
cional

nsumer Action

ipino-American Political
sociation

rmandad Mexicana Nacional

erdenominational
inisterial Alliance

tino Issues Forum

ague of United Latin
nerican Citizens

exican-American Political
sociation

w Bayview Committee

kland Citizens Committee
Urban Renewal (OCCUR)

oenix Urban League

cramento Urban League

n Francisco Black
amber of Commerce

orld Institute on Disability

)-CHAIRS:

orge Dean, President & CEO
oenix Urban League

n Gamboa, Executive Director
tino Issues Forum

GAL COUNSEL:

bert Gnaizda, Public Advocates

May 16, 1994

Frank Newman
Under Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Eugene Ludwig
Comptroller of the Currency
250 E. Street, SW
Washington, D.C. 20219

Re: OPPOSITION TO PROPOSED SINGLE REGULATORY AGENCY COMPROMISE

Dear Frank and Gene,

As you are aware, the Greenlining Coalition has been among the most openly supportive community groups regarding Secretary Bentsen's proposed single regulatory agency.

We support a single regulatory agency for efficiency reasons and because we believe that the Federal Reserve unduly influences the CRA process, particularly at merger time. (Our N.Y. Times ad criticizing the Federal Reserve's undue CRA authority will be appearing on May 19th.)

We strongly oppose any compromise that permits the Federal Reserve to maintain, much less increase its CRA authority. The recent so-called compromise proposal appears to cede undue and unnecessary CRA authority to the one regulatory body that opposes President Clinton's and the Treasury's commendable CRA positions.

Sincerely,

Robert Gnaizda
General Counsel
Greenlining Coalition

John C. Gamboa
Co-Chair
Greenlining Coalition

Under Secretary Newman
Comptroller Ludwig
May 16, 1994
Page Two

Ortensia Lopez
Executive Officer
California Hispanic
Chambers of Commerce

Willis White
President
California Black
Chambers of Commerce

cc: Senator Boxer
Senator Riegle
Congressman Gonzalez
Congressman Kennedy
Congresswoman Waters

BANKING INDUSTRY REGULATORY CONSOLIDATION

WEDNESDAY, MARCH 2, 1994

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met in room 538, of the Dirksen Senate Office Building at 10:08 a.m., Senator Donald W. Riegle, Jr. (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The Committee will come to order.

Let me welcome all those in attendance this morning, and begin by acknowledging the presence of our panel of regulators and welcome them here this morning.

We have, of course, Alan Greenspan, Chairman of the Federal Reserve Board; Eugene Ludwig, the Comptroller of the Currency; Andrew Hove, Jr., the Acting Chairman of the FDIC; and Jonathan Fiechter, the Acting Director of the Office of Thrift Supervision.

This is a very important hearing today because we want to move ahead on the issue of consolidation of the bank regulatory agencies, addressing the fact that we've got a great deal of overlap and duplication.

Even more worrisome is the concern that things don't get attended to properly because no one regulator has the authority to really act as the lead player, therefore major problems can arise.

I have asked our Federal financial regulators here today to testify on the establishment of a new Federal Banking Commission.

Yesterday, Secretary Bentsen testified that the necessity of consolidating the bank regulatory system is growing more and more urgent. He testified, and I quote:

> The current Federal bank regulatory structure is senselessly convoluted, places a serious drag on the Nation's banking industry, and the economy in general, has failed to affectively protect the stability of the banking system, and ill serves the financial services needs of the American people.

He also testified, and I again quote:

> The real risk lies not in change but in missing the opportunity to effect badly needed reform.

There is no other country in the world that has a regulatory system that is as convoluted and confused as ours and I think it is important to recognize that if this continues it will lead to a significant reduction in competitiveness of our federally-insured depository institutions.

Regulatory consolidation streamlining is not, by itself, a cure-all, but it's a very important step in what needs to be done, in addition to other steps we are taking and other legislative vehicles in this Committee, to create a healthy and profitable banking industry.

Secretary Bentsen, yesterday, made the point that in the interests of creating a more efficient bank regulatory system for the future, the Treasury Department itself is willing to give up regulatory control over federally-insured deposit institutions that now hold some 62 percent of Federal bank and thrift assets.

I think this is an unprecedented gesture on the part of the Treasury to create a more efficient, independent bank regulatory system, and I believe that all the regulators, and in particular the Federal Reserve, has to make a similar effort to work cooperatively in order for us to streamline and modernize the system, thereby eliminating some of the costly and unnecessary bureaucracy.

Yesterday, virtually every Senator who spoke stated the view that the status quo is unacceptable and something must be done to improve efficiency and avoid duplication of effort.

If our depository institutions are to remain competitive in the 21st Century, I think our regulatory supervisory system has got to go through this kind of intelligent streamlining and consolidation. Now is the time to get this done.

I intend to move, shortly after the completion of these hearings, with a mark-up, and I will put a Committee Print in front of the Committee because we're going to move ahead on this issue.

I want to just say one other thing, and that is I'm deeply respectful of the prerogatives of each regulatory body, and we take these questions very seriously in this Committee.

I'm willing to listen very carefully to any legitimate concerns and questions, that have to be dealt with and resolved here, with care and balance.

What I would not want to see is a stubbornness in the defense of turf. I must just say to you, I have yet to see an agency of Government that does not have these bureaucratic tendencies. Every single one does. And the Congress isn't immune from it either.

But that's no excuse for an insistence on the status quo and an unwillingness to move cooperatively. I've seen too many instances where we have regulators sit right at this table and quibble to the point where somebody has to yield a little more than somebody else, either in terms of turf or resolving a matter in terms of the substance of the issue. Very often, we've had to just force people to finally break these impasses and come to decisions in order to get sensible decisions made.

Maybe that's part of our function. We have to do that because bureaucracies become rigid and self-protective. I don't want to see that happen here.

Chairman Greenspan, you and I have had to thread the needle on very complicated issues to make sure that we were building in safety and soundness, and at the same time providing the operating latitude that the Fed felt it needed to do certain things.

That certainly was true with the late Bill Taylor. I recall one conversation that you, he, and I had about how to reach a sound, sensible balance in the structure and process of law.

I'm asking for the same thing here. I want to get this done. What I do not want to see at the end of the day is people digging in, unwilling to reach sensible balanced answers. And I think there's a real damaging cost. We're here to try to find good answers, and I presume everybody brings that intention to the table today.

I'd be very interested in going through the points in your prepared statements. I must say to Chairman Greenspan, who is a friend and colleague who I greatly respect, we didn't receive the Fed testimony until late last night. And, as I said to you beforehand, and I'll say again, there's really no excuse for that. I know the Fed's not understaffed. This is an issue where we're interested in carefully reviewing all points. We want to be able to evaluate them, to be able to take them up in a hearing with sufficient time for analysis that, unfortunately, we have not had in this case.

I don't hold you personally responsible, but somebody down there has to be able to function a little quicker than that, especially when you've got long-standing rules that regard these kinds of things.

Let me stop at that point, and let me ask my colleagues for their comments.

Senator Faircloth, opening statement?

OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Good morning, and thank you, Mr. Chairman.

I especially want to greet Mr. Greenspan. Having looked at the fourth quarter GDP, the 7.5 percent annual rate of growth on that, I think it thoroughly vindicates your decision to raise interest rates.

There is much liquidity in the economy and more than most people had recognized. You saw it early. We have seen inflation in financial assets, we're seeing inflation in the commodity market, and we will soon begin to see it in the wholesale and the retail sector.

I predict that a year from now, some of the same people that were opposed to your decision and were criticizing you for making the decision will wonder why you didn't do something to stop inflation earlier before its roots became more entrenched.

Mr. Chairman, this morning, we continue our discussion about the future of bank regulations. Some want a very modest reform; others want to tear apart what has been built up over the years in order to experiment with something new and an untried system.

One thing is certain. If the current environment in regulatory agencies shows us anything, it's that we should absolutely not do anything to weaken the power of an independent Federal Reserve.

Recent events concerning the Madison Guarantee Savings & Loan—and I promise not to devote this hearing this morning to a rehash of that—but the recent events concerning that and the manner in which the Administration has handled it, has made it abundantly clear that we need to keep an independent control over the fiscal systems of the country.

Just last week, we learned from Roger Altman, he went to the White House to give a "heads-up," whatever that means, about possible legal action against the First Family. We saw from the FDIC, in a very, very weak report and examination of Ms. Clinton and

Webb Hubbell, some conflicts, that Senator D'Amato said any schoolboy could see. And, despite the fact that the records were never checked and the First Lady was never interviewed, we saw these reports that clearly indicated that no attempt had been made to get to the bottom of it.

But the issues that we're facing today cast a pall over the idea of taking any power from an independent Federal Reserve and consolidating it under a new Federal Banking Commission controlled by not President Clinton—he's the President today—but the system we're talking about building would be controlled by whatever President of whatever ilk might get into the White House. He would have the ability to manipulate it and to move it.

I think that is the worst possible situation that we could have happen and the most devastating thing we could do to the fiscal integrity and responsibility in this country.

In the current climate, with Congress refusing to meet its regulatory oversight responsibilities, I would not vote to take one iota of authority away from the Federal Reserve and an independent Federal Reserve.

We mentioned that other countries are more efficient. Well, the Federal Government might be the world's most inefficient operation, but if we're going to tolerate inefficiency and give ourselves time to think, and maybe even with overlapping responsibilities, if that slows down the process and ensures integrity in the financial institutions of this country, then that's what I support and am for. I am opposed to any change that would do anything to deplete the power and authority of the Federal Reserve.

I thank you.

The CHAIRMAN. Senator Shelby.

OPENING STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Mr. Chairman, the first thing I want to do is welcome all the regulators here. I want to commend, publicly, the role that Chairman Greenspan is playing in this legislative fight.

I commend you and I hope that you will stick to your guns, Mr. Chairman, that you will not be steamrolled into something legislatively proposed that might not be in the best interests of the monetary system in this country or the banking system.

While I agree, Mr. Chairman, that the present system is inefficient, I have serious, serious reservations about consolidating the supervisory functions of the Federal banking regulators into one agency.

While the present system is unnecessarily complicated, it does provide a system with checks and balances that have been beneficial to the safety and to the soundness of the banking system.

While I strongly support reducing the regulatory burden, I believe it must take a back seat always to safety and soundness.

I also think, Mr. Chairman, it's interesting to note that, while we in Washington may perceive the present system as being unnecessarily burdensome on banks, a lot of the banks do not seem to agree.

I've heard from a number of banks in my State and elsewhere in the country on this issue. Ironically, each bank I've talked to tells me that it is regulated by the best regulators, and that the

quality of supervision it receives is superior to that provided by the other regulators.

Bank regulators must be like Congress. Collectively you aren't held in the highest esteem, but individually you are well-liked and respected by some of the people that you regulate.

I have a number of concerns, Mr. Chairman, over the current proposals for regulatory consolidation. First, I'm concerned over the potential consequences to the banking system of having one regulator, one board whose members would be nominated by the President and confirmed by the Senate, and which would include the Secretary of the Treasury.

I believe it could be unduly influenced by the political agenda of the party in power, whichever party that might be. This isn't a criticism of either party, but I strongly believe that bank regulation should be independent, independent from the political process.

Moreover, the present system provides checks and balances that have contributed to the safety and soundness of the banking system. These checks and balances would be lost, I believe, under a system with one regulator.

Second, I'm concerned that the Federal Reserve's ability to conduct monetary policy could be hamstrung if the Fed were to lose its supervisory role over banks. I do not buy the argument that the Federal Reserve will have sufficient information to conduct monetary policy just by reading the reports provided by another agency. The Fed is held in extremely high regard as a regulator. I believe it would be unwise to curtail its supervisory capacity.

Third, though not less significant, is the importance of protecting the dual banking systems. States have served as important laboratories of innovation over the years. One monolithic Federal regulator would jeopardize the vitality of the dual banking system.

Mr. Chairman, regulatory consolidation is an interesting concept. I know you would agree that in undertaking this task, it's extremely important that we do it right or not do it.

I commend you for the excellent series of hearings you've scheduled this week, and trust that we'll receive a great deal of assistance from the witnesses.

I look forward to the question and answer period, but I believe that we should be looking at this concept very, very carefully.

The CHAIRMAN. Thank you, Senator Shelby.

It's instructive, if I may just make an observation before yielding to Senator Murray, I look at the table. We've got four bank regulators out here, and each of you are Presidential appointees. We don't have any bank regulators that aren't Presidential appointees. That means we get a chance to vote on whether we confirm them or not. But we wouldn't be changing that. Every single one of you has had to be confirmed, and that would be the same in the future.

Senator SHELBY. But, Mr. Chairman, if you would yield?

The CHAIRMAN. Sure.

Senator SHELBY. We understand that from this Committee, because just about every one of them have come through this Committee that you chaired and we serve on. We realize that.

But the Fed is a unique organization here, long-terms. Much longer terms and a unique role, and I believe that the central bank

plays a tremendous role in our economy and in the stability and the safety and soundness of our banking industry.

The CHAIRMAN. I think that's a view that's generally shared; it is certainly my view, as well, but that doesn't cut against the issue of how we do our regulatory process. In any event, we'll thrash that out.

Senator Murray.

OPENING STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. Thank you, Mr. Chairman. Especially thank you for holding this series of hearings on what I think might be some of the most important legislation this Committee considers this year.

I agree with you we don't want turf wars and we need to streamline the process. I think we have to be careful that we achieve what we set out to do in the process. That's why I'm looking forward to hearing what you have to say today.

I come to this because a year ago, when I was appointed to this Committee, my office was immediately filled with bankers from my State, from Seattle to Spokane, telling me that they were overregulated, that there was a maze of regulatory agencies, and that we had the most complex system in the world.

So, when the Administration put out this legislation, I expected them to applaud it wholeheartedly, and was quite surprised at their reaction, which was very negative. I'm curious as to why the industry that this legislation is supposed to help is not falling all over themselves to get it passed, because I do believe that why we're considering this, is that we need to get past that maze of overregulation.

Does this legislation achieve that? That's clearly the question I think that we need to hear and we need to answer.

I look forward to your testimony today and to working with you on this issue.

The CHAIRMAN. Thank you, Senator Murray.

Senator D'Amato.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Thank you very much, Mr. Chairman.

I welcome our distinguished panel here, some we've been seeing more regularly than others.

One's missing but that's——

Mr. Chairman, first of all, let me congratulate you for your perspicacity in continuing in this effort to improve the antiquated banking regulatory structure. I believe that everyone recognizes that there's room for improvement. All of our colleagues have expressed support in the attempt to make some improvement.

Second, as Secretary Bentsen indicated, there's enormous confusion and misunderstanding about the contents and the impacts of the various proposals.

The Treasury's final proposal was only made available yesterday, so that's moving and changing, and that's good. That's as it should be, some give and take.

I have not seen the Federal Reserve's response and, obviously, they're going to need some time to look at and to digest it.

My view is that this process to date has been more argument than debate, and it's generated more heat than light. I would hope that we could begin to hone in on what should be done, what can be done to improve the process and yet to guarantee the important functions that are indispensable to the Federal Reserve.

And, yes, to maintain that kind of independence that is absolutely essential, essential in every area, as it relates to its investigatory abilities and powers and charges, as it relates to its oversight, and as it relates to dealing with systemic problems. This is important.

So, as the cosponsor of the consolidation bill, I would hope that we would continue to urge the banking industry, the agencies who emphasize the overriding benefits of making the kinds of improvements that will make it possible for the bankers to do banking without there being a continual process of various groups coming in to do the same thing that essentially was done by one earlier.

Working together, I think with the cooperation between this Committee, the Fed, and the Treasury Department, we can develop and pass the bill.

I asked Secretary Bentsen yesterday, and I ask Chairman Greenspan today to attempt to boil down their differences and attempt to reconcile. I think we can do the business of the people in that way. I am hopeful that with good will and real effort it's possible that we can keep the best of this system and yet improve upon it.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Roth.

OPENING STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

Senator ROTH. Thank you, Mr. Chairman.

Like you, I agree that reform is needed. Although I am less certain than you that the Treasury's proposal provides all the right answers.

Yesterday I noted my concern about the impact of the proposal on the health of the dual banking system. I did this not to raise dust but to express a doubt shared by many. While I believe that Secretary Bentsen intends no harm to the dual banking system, there nevertheless may be unintended consequences.

I am not persuaded that the fact that State regulatory authority is not diminished and that the totality of Federal regulation has not increased answers that concern. Nor do I find analogies with the SEC or the FDA apt. What seems to be overlooked in discussing the Treasury proposal is that, unlike any other area of regulation, the proposed Federal regulator of State-chartered institutions will also have the function of creating Federal institutions. I cannot think of another area of Federal regulation where this is so. It's unique. I'm concerned that the natural tendency of the Federal parent to favor its own children, rather than other children, may create pressure for these other children to seek adoption within the Federal family, with the result that the vitality of the dual banking system is diminished.

Mr. Chairman, the Treasury proposal is appropriately touted as one of the Administration's Reinventing Government initiatives. In the Committee on Governmental Affairs we are processing several others. In discussing these proposals, a recurring theme is the con-

cept of one-stop shopping. This concept benefits the regulated, not necessarily the regulators.

As today we have before us Chairman Greenspan, it may be appropriate to discuss one-stop shopping for bank holding companies and their subsidiaries. I am uncertain that it is the right solution in this context, but if any of the witnesses have given it some thought, I would appreciate hearing their insight.

I look forward to the testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Roth.

Gentlemen, again, we welcome you all. We'll make your statements a part of the record. And we'll go right down the table. Chairman Greenspan, we'll start with you and maybe I can get you to pull that mike over so the people in the back of the room can hear you clearly.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE BOARD, WASHINGTON, DC

Chairman GREENSPAN. Thank you very much, Mr. Chairman.

As you indicated, I'd like my complete text to appear for the record, and I'll try to excerpt from it. Even so, I regret, because of the complexity of the subject, I'm a little longer than I would ordinarily be with a four-person panel.

It's certainly a pleasure to appear today before this Committee to give the views of the Federal Reserve Board on proposals to consolidate the banking regulators into a single agency. We have prepared a detailed analysis of such proposals, which I've attached to my statement. My remarks this morning will highlight that analysis.

The proposals to create one Federal bank regulator have the clearly stated objectives of reducing the Government's costs of regulating and supervising banks, of reducing bankers' costs and burdens from duplicative examination and overlapping supervision, and, in general, making the supervisory process more efficient and more accountable. The Federal Reserve Board shares these goals. We disagree, however, with the approach of one regulator for achieving these objectives. The Board believes that it is possible to achieve virtually all of these proposals' objectives without creating the risks of one regulator that so trouble us.

In reaching this conclusion, the Federal Reserve tested various proposals against the fundamental principle that the purpose of regulation is to enhance the capability of the regulated entity to contribute effectively to the Nation's long-term economic growth and stability. We have concluded that for this to be accomplished, four subsidiary principles must be achieved.

First, there should not be a single, monolithic Federal regulator.

Second, every bank should have a choice of Federal regulator.

Third, there should be only one Federal regulator for all of the depository institutions in any single banking organization.

Fourth, the U.S. central bank should continue to have its essential hands-on involvement in supervision and regulation.

A consolidated, single regulator would deprive our regulatory structure of what the Fed considers to be the current invaluable restraint on any one regulator conducting inflexible, excessively rigid

policies. Laws on bank regulation and supervision must be drawn very generally, leaving the specifics to agency rulemaking. This vests the agencies with a broad mandate and not inconsiderable discretionary power. Hence, a safety valve is vitally needed to avoid the exercise of arbitrary action. A denial of, or severe limitation of charter choice closes off the safety valve, inevitably leading to a greater micromanagement of banks and a lessening market for bank credit. We must avoid a regulatory structure that inhibits economic growth.

The present structure provides banks with a method—albeit one neither easily accomplished nor often taken—of shifting their regulator, an effective test that provides a limit on the arbitrary position or excessively rigid posture of any one regulator. The pressure of a potential loss of institutions to other agencies has inhibited excessive regulation and acted as a countervailing force to the bias of a regulatory agency to overregulate.

The dual banking system and multiple Federal regulators have facilitated diversity, inventiveness, and flexibility in our banking system so important to a market economy subject to rapid change. A single Federal regulator would effectively end the dual banking system. It would become an empty shell if a State-chartered entity had no choice of Federal regulator or—reflecting a recent FDICIA provision—different asset powers. The dual banking system cannot survive, in my judgment, consolidation at the Federal level. I, as well as my colleagues on the Board, believe that would be a tragic loss.

In addition to the effective loss of the dual banking system, the single regulator contemplated in the current proposals would be disconnected from broad economic policy issues. This is a problem because a regulator that does not have macroeconomic responsibility for its actions is likely to inhibit prudent risk-taking by banks, thus limiting economic growth and stability. The central historic purpose of banking is to take risks through the extension of loans to businesses and others. Economic growth in our system could not occur without risk-taking by entrepreneurs and small and large businesses. Risk-taking requires financing. Thus, either an unwillingness or an inability of lenders to take risks would slow the expansion of our Nation's employment and income.

Indeed, a single regulator with a narrow view of safety and soundness and with no responsibility for the macroeconomic implications of its decisions would inevitably have a long-term bias against risk-taking and innovation. It receives no plaudits for contributing to economic growth through facilitating prudent risk-taking but it is severely criticized for too many bank failures. The incentives are clear.

The Federal Reserve's stabilization objectives cause us to seek to avoid either excessive tightness or ease in our supervisory posture. The former leads inevitably to credit crunches, and the latter to credit policies that contribute, with a lag, to bank losses and failure. This is not to say, as some have advocated, that the Fed itself should be the only regulator. A single regulator Fed would be prone to arbitrary and capricious behavior as would any other single bank regulator. We would thus oppose such an initiative since, as a single regulator, we would inevitably drift to increasing day-by-

day control of banking institutions who would soon become less innovative and competitive—a severe loss to the Nation.

Not only is it important that one of our regulators have macroeconomic responsibility in order to carry out the regulatory function properly, but also our central bank must continue to have hands-on involvement in supervision and regulation in order, effectively, to carry out its macroeconomic responsibilities. Joint responsibilities make for better supervisory and monetary policy than would result from either a supervisor divorced from economic responsibilities, or a macroeconomic policymaker with no involvement in the review of individual banks' operations. Without the hands-on experience of regulation and supervision, and the exposure to the operations of banks and markets provided by such experience, the Federal Reserve's essential knowledge base would atrophy. Its deliberations would become increasingly academic, and the Nation's central bank would soon resemble an ivory tower rather than an institution necessarily involved with the day-to-day activities of our economic and financial system. It is our knowledgeable examiners and supervisors—knowledgeable about banks, financial markets, and the payment systems that connect them—that provide the expertise that the Fed needs. And the fact is that we simply could not retain such staff if they were not actively involved in the process; reading reports or joining as junior participants in a handful of examinations would not be sufficient, in our judgment.

Removing the Federal Reserve from supervision and regulation would greatly reduce our ability to forestall financial crises and to manage a crisis once it occurred. In a crisis, the Fed could always flood the market with liquidity through open market operations and discount window loans. But, while rapid liquidity creation is often a necessary response to a crisis, supervision and regulation responsibilities give the Fed insight and the authority to use less blunt and more precisely calibrated techniques to manage such crises and, more importantly, to avoid them. The use of such techniques requires both the clout that comes from supervision and regulation, and the understanding of the linkages between supervision and regulation and macroeconomic growth and stability.

The Fed is required to play the key role when systemic breakdown threatens. The attachment to my statement provides some detail about Federal Reserve involvement in financial crises over the last decade. As you review it, I request that you consider certain key questions.

Could the Fed, without supervisory responsibilities, have successfully managed the Mexican debt crisis of 1982, the 1985 collapse of Ohio and Maryland privately insured thrifts, the stock market crash of 1987, or the Drexel failure of 1990?

Would the banking community have been persuaded to respond, as they did in each of these cases, by a central bank with much more limited authorities to affect events? Would the Fed have been able to play a role in persuading many of the banks to complete the payments necessary to prevent payments gridlock without supervisory knowledge and especially authority?

Finally, would a single bank regulator, with no macroeconomic stabilization responsibilities, have given the proper weights to financial market stability and economic growth? Without market ex-

pertise, would such a regulator have recognized, early enough, many of the problems central to resolution of these crises?

In my judgment, Mr. Chairman, the risk that the answer to all of these questions is "no" is too great to take.

There are ways, short of the creation of a single agency, to address the problems in the current regulatory structure and reduce the costs of regulations. The crux of the issue is duplicative examination of banks. This problem could be eliminated by a regulatory system that maintained two Federal regulators, but provided that, in general, only one of those regulators supervised all the depository institutions in any banking organization.

While there are many ways to achieve an improved regulatory structure, one such approach supported by the Federal Reserve Board that could be implemented with a relatively modest series of reforms would contain the following provisions:

Merge the OCC and the OTS. This organization would become the Federal Banking Commission.

Remove the FDIC from examining healthy institutions.

Put all independent national banks, all lead national banks that are a part of a holding company, and all thrifts under the purview of the Federal Banking Commission; and put all independent State banks, and all lead State banks in a holding company under the purview of the Federal Reserve.

Provide that the supervisor of the lead depository in a banking organization also be the supervisor and regulator of all of the depository institutions in the organization regardless of the charter class of those affiliates.

Finally, treat all U.S. activities of foreign banks as now, with adjustments where necessary to reflect the changes in the regulatory structure described above.

The Board has not yet adopted a final position on the supervision and regulation of bank holding companies and their nonbank affiliates. There are two broad options, and a strong case can be made for each:

Under the first option, all holding companies and their nonbank affiliates could remain under the Fed's jurisdiction, continuing to provide uniform rulemaking for competitive equity and a substantial role for the Fed in shaping the financial structure, so useful for stabilization and systemic risk purposes.

Under the second option, the jurisdiction of virtually all holding companies could be split between the Fed and the Federal Banking Commission on the basis of the charter class of the lead bank. However, for systemic risk reasons, jurisdiction over the holding companies and nonbank affiliates of a modest number of banking organizations that meet certain criteria—such as large size and payment and foreign activity—would be retained by the Fed even if the lead bank of the organization had a national charter organization.

Under either option, the number of banking organizations subject to multiple regulators would drop sharply.

Whichever holding company option is selected, the general proposal would have the Fed supervise and regulate State nonmembers with these banks being a significant addition to our existing regulatory load. This expansion of the Fed's supervisory function

rests solely on the notion that in a two-agency structure, it is desirable to have supervision and regulation responsibility defined clearly by charter class in order to preserve the dual banking system. The Board makes no case that responsibility for such banks—that account for almost one-quarter of bank assets—is needed for financial stability and monetary policy purposes. However, responsibility over banks of various sizes and locations, as under our existing authorities, is required if the Fed is to perform its functions effectively.

The Board's approach would achieve essentially all of the benefits of one consolidated regulator while incurring virtually none of its risks. It eliminates duplicate supervision of depositories in a single banking organization and greatly reduces overlapping regulation. It maintains the dual banking system and permits any bank to change Federal regulator by changing charter, thus ensuring a set of checks and balances on the arbitrariness of a single regulator. It maintains a healthy process of dynamic tension in bank rulemaking. It maintains the practical knowledge and skill, and the influence and authority of the central bank, so critical to crisis prevention, crisis management, and monetary policy. It maintains the valuable perspective the central bank brings to supervision.

In short, the proposal would avoid an inflexible, single regulator, preserve the dual banking system, assure that an economic perspective is brought to supervision and regulation, and maintain a strong central bank.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Chairman Greenspan. We'll come back to those points a little later.

Mr. Ludwig, we'd like to hear from you now. We'll make your statement a part of the record.

STATEMENT OF EUGENE A. LUDWIG, COMPTROLLER OF THE CURRENCY, WASHINGTON, DC

Mr. LUDWIG. Thank you very much, Mr. Chairman and Members of the Committee, for this opportunity to present my views on the need to reform our bank and thrift regulatory structure.

Before doing so, I want to applaud you, Mr. Chairman, and Senator D'Amato for your leadership in this area. Both you, Mr. Chairman, and Senator D'Amato have joined forces to champion reform with your own initiatives. I'm heartened by this considerable degree of common understanding which is shared by Chairman Gonzalez and many Members of the House Banking Committee. Clearly, this is not a partisan issue but a serious problem that calls out for a prompt solution. Indeed, your views, and those of Chairman Gonzalez, have weighed heavily in the development of the Administration's own proposal, which was presented to this Committee yesterday by Secretary Bentsen. I admire your willingness to take on this controversial issue.

You are doing the right thing simply because it is right. So, too, is Secretary Bentsen. The Treasury would not see its power and prestige grow if the Administration's proposal is enacted—on the contrary, the Treasury would relinquish its traditional, institutional instruments for banking regulation: the Office of the Comptroller of the Currency and the Office of Thrift Supervision. But

Secretary Bentsen views regulatory consolidation as necessary if we are to create a better American financial system, and so he has taken a step practically unheard of in Washington: recommending a change that brings himself and the institution he heads less, rather than more, authority. His statesmanship in this matter serves as an example to all of us in Federal Government service.

I have a detailed written statement that discusses the reasons why I feel so strongly about this reform. In the interests of time, I would like to submit that written statement for the record, and focus my comments today on why I believe the need for reform is urgent—even though this need may not appear so at this moment. I will answer three questions: (1) Why does the current system need to be fixed? (2) Why does it need to be fixed now? and (3) Why is the Administration's plan the right way to fix it?

There is an old saying: If you are not part of the solution, you are part of the problem. Our system of banking supervision is supposed to provide stability for the banking system and the economy. But in recent years it has repeatedly failed us—becoming part of the problem, instead of part of the solution. The evidence is clear. Our current supervisory system—fragmented, cumbersome, and slow to respond—failed to prevent a series of crises over the last decade that inflicted massive harm on the economy. In failing to supervise thrifts effectively, a poorly-equipped Federal Home Loan Bank Board failed to prevent the S&L crisis. In failing to develop a coordinated response to the bank problems, our system of multiple Federal supervisors failed to prevent the massive wave of bank failures in the 1980's and the ensuing credit crunch that contributed to the severity of the last recession.

Not only does the current structure not work, it has worked against the very safety and soundness goals bank supervision seeks to achieve. As a result, supervision failed repeatedly in the past decade. And, it failed us when we most needed it, when crises in agriculture, energy, and real estate—plus a recession—rocked the economy. The repeated failures of bank and thrift supervision cost the American economy hundreds of billions of dollars.

Every commissioned study of our Federal banking regulatory system since 1949 has recognized the need for major consolidation of our supervisory mechanism—and let me emphasize that I am talking about eight major studies by eight distinguished Committees over a period of 40 years.

Moreover, virtually every knowledgeable observer of the system has concluded that the current system does not work and that it needs to be fixed. Fed Governor John LaWare, for example, has written:

> The Administration is unquestionably right. Our regulatory structure requires too many banking organizations to deal with too many regulators, each of which has overlapping, and too often maddeningly different, regulations and interpretations. Something ought to be done about it.

I could not agree more.

We have attached a number of other such observations as an addendum to our written statement. Mr. Chairman, should a structure so universally condemned be left standing?

At present, Mr. Chairman, we are in the midst of a powerful cyclical recovery. A favorable interest rate environment and other,

largely transitory, factors have boosted the profits of banks and thrifts. A steadily improving economy has improved credit quality and enabled bank managers to clean up their balance sheets. And consolidation of the banking industry continues to force the weaker players from the market. These positive trends are welcome, but they must not lull us into a false sense of security.

The recent positive developments are transitory—they will not go on forever. Interest rate environments and market conditions have their ups and downs. The cycle will turn, and problems will appear. I cannot say what the next fire will be, but I can say for certain there will be a fire next time. What will happen if we have not rebuilt our fragmented and broken regulatory system? There is every reason to believe that when the next crisis strikes, the costs will again be enormous.

We need to fix our fragmented and broken system now, while the profitability and capitalization of depositories are strong. We cannot afford to wait until the next crisis forces us to turn our attention to what we should have done before. I am concerned that, if we do not reform our system of supervision, we will be leaving ourselves open to problems of the same magnitude as those we experienced in the 1980's.

Mr. Chairman, my written statement also discusses in detail three key areas upon which sound supervision rests: reporting, regulatory prescriptions, and supervisory practices. My written statement shows why our current system too often yields results that are needlessly late and "second best" in all three areas. It shows, in nuts and bolts terms, why the current system does not work and why it cannot be made to work—why we cannot repair and why we must, instead, rebuild.

I want to touch briefly on an example from each area. First, reporting: As you know, the Call Report is a lengthy presentation of assets, liabilities, income, and expenses that all banks must file with Federal banking authorities. There were vast differences in Call Reports filed by national banks, State nonmember banks, and State member banks as late as the mid-1960's. President Johnson demanded that the Federal banking agencies hammer out a common document.

Fourteen years later, in 1978, a frustrated Congress created the Federal Financial Institutions Examination Council to coordinate that process. Ten years later, 24 years after the process began, basic, though not complete, uniformity was reached in part through log-rolling by the agencies; I will accept your additional item if you accept mine. As a result of this log-rolling, the number of different items filed by banks with assets under $100 million doubled over the last 9 years from 320 items to 762 items, and the growth has been similar for institutions in every size class.

By the way, Congress, in 1978, also called on the regulators to develop a common examination report. Sixteen years later, we have reached agreement only on what should appear on the cover sheets of this report.

Second, an example from the area of regulatory prescriptions: One would think that the regulators could reach agreement on something as fundamental as capital and accounting standards—but one would have to think again, as you know from the annual

reports we file with the Banking Committees. The last report described differences in 27 areas of capital and accounting standards—this after more than a decade of trying to achieve uniformity and a statute that requires uniformity.

Third, an example from supervisory practices: Separate supervisors result in disparate supervision, supervision that differs across a wide range of standards—from those for assessing credit quality to those for assessing the quality of bank operations. For the managers of holding companies owning a variety of banks, the cost of disparate supervision can be great. It can be difficult to manage individual banks efficiently when the supervisory standards faced by one bank are not the same as those faced by another.

At the end of last September, 413 holding companies, with assets of more than $2.4 trillion, 52 percent of all assets held by banks and thrifts, were confronting this problem every day of the week. In some cases, examiners from the different agencies have attempted to keep supervisory burdens to a minimum by conducting joint examinations, sharing examination reports, and conducting joint meetings with holding company management. At the other extreme, however, there are companies where there is little, if any, sharing, and the holding company's employees and managers must provide the same information to separate teams of examiners and meet separately, within relatively short periods of time, with examiners from all different agencies.

Obviously, Mr. Chairman, our supervisory system, which encourages such duplication and inefficiency, is ill-equipped to deal effectively with integrated financial services organizations. Because of separate jurisdictions, there is always the danger of supervisory issues falling between the cracks. The way to address these problems is to have the same regulatory agency oversee the holding company and all the depository institutions in the holding company.

Mr. Chairman, the Administration's proposal to create a Federal Banking Commission would address all these types of problems in the same way that you and Senator D'Amato have proposed—by creating a single Federal supervisor for banks and thrifts. It is the right way to fix the problems, and I completely support it.

Under the Administration's proposal, this supervisor would oversee holding companies and the depository institutions within them. This agency would be focused on a single mission—bank supervision—instead of having dual missions that sometimes conflict with each other. The single regulatory agency the Administration's proposal would create would ensure against the possibility of problems just slipping through the cracks. Further, the Administration's proposal would end competition in laxity. It would end duplication of regulation, examination, and supervision. It would ensure accountability and more efficient decisionmaking. And it would save considerable amounts of money, somewhere between $150 million and $200 million annually in direct savings, with institutions saving millions more indirectly.

In addressing our system's fragmentation and flaws, however, we must protect certain basic elements in our financial system. I am well aware of that. In particular, we must protect the dual banking system and the strength and independence of both the FDIC and

the Federal Reserve. The reform proposal put forward by the Administration would preserve and enhance these elements.

Despite the clear and urgent need for this reform, success, I know, will not come easily. Some of those who agree that we need reform in general, disagree with the particular reform that has been proposed. We need to understand their concerns and take them under consideration as we move forward—but most of all, we need to move forward.

If we do not move forward, we face the inevitable consequences of an inadequate regulatory structure, one that failed to prevent the massive wave of thrift and bank closings in the 1980's, failures that cost the taxpayer and the Federal Deposit Insurance Corporation many billions of dollars. I stand ready, Mr. Chairman, to help you and the other Members of this Committee move forward. I welcome your questions.

Thank you very much.

The CHAIRMAN. Thank you very much.

Mr. Hove, I've got my eye on the clock here and we've got Members that are going to want to ask questions, and you're not a man of great length, normally, when you give your statements in any case, so we'll make your statement a part of the record, and if you can summarize it, we'd welcome that.

Mr. HOVE. I'd be glad to.

The CHAIRMAN. But take the time you need. I don't want you to feel that you don't have the time you need.

Mr. HOVE. Thank you, Mr. Chairman.

Senator SARBANES. But don't take too much time.

Mr. HOVE. Right.

[Laughter.]

STATEMENT OF ANDREW C. HOVE, JR., ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION, WASHINGTON, DC

Mr. HOVE. Thank you, Mr. Chairman, and Members of the Committee. I do appreciate the opportunity to testify this morning on behalf of the Federal Deposit Insurance Corporation on the proposals to consolidate the financial institution regulators.

The FDIC favors consolidation of the financial institution regulatory structure. The current system is not a scheme that a rational individual would design from scratch. The system is a result, partly, of ad hoc responses to particular financial crises that have occurred over a period of 150 years.

The current and improving health of the industry makes this a good time to simplify the regulatory structure that we've inherited.

In pursuing the goal of regulatory consolidation, however, we must be careful not to destroy the meritorious elements of the current system. After all, the banking industry, under the present regulatory scheme, has been a major contributor to growth in the U.S. economy, which is one of the most dynamic economies in the world.

Moreover, we must remember that the banking industry has coped successfully under the current regulatory structure with the problems of the 1980's without requiring taxpayer funds.

I would like to focus on what is needed to preserve the effectiveness of one fundamental component of the system—that is deposit insurance.

The Administration's proposal and all the other major proposals of the last several decades have recognized the central role of deposit insurance. The FDIC needs certain essential authorities in order to effectively fulfill its deposit insurance responsibilities under a consolidated regulatory structure.

These authorities fall into five main categories: independence, funding, information, enforcement, and resolution.

First is independence, and that is at the top of the list of what an effective Federal deposit insurer should have. We have only to recall the experience of FSLIC to realize the importance of independence.

The Federal Savings and Loan Insurance Corporation, a subsidiary of the Federal Home Loan Bank Board, whose mandate included serving as an advocate for the regulated industry, was not independent and was not able to properly address the industry's problems.

The second essential authority involves the issue of FDIC funding. A crucial contributor to the independence of the insurer is the authority to determine its own budget. Consistent with current practices, the FDIC should retain its budgetary freedom and should have the authority to set assessment rates for each institution. It is important for the insurer to retain assessment authority, both to maintain the insurance funds and to provide fair and effective risk-related assessments.

The third category of authorities that the FDIC would continue to need, if the current system is consolidated, involves information. To be effective, the FDIC would require timely access to sufficient information. This means access to information needed to understand and stay abreast of the changing nature of the risks facing the banking industry.

The insurer also needs sufficient information to have an adequate basis to conduct corrective resolution and liquidation activities. Several conclusions flow from the FDIC's information requirements.

One is that the FDIC, obviously, would continue to need ready access to all reports and records of the Federal Banking Commission and of State authorities relating to depository institutions, their holding companies, and their affiliates, as well as the banking and thrift industries in general. In addition, the FDIC needs a voice in what information is collected.

Another conclusion is that the FDIC Chairperson should be a member of the proposed Federal Banking Commission. This would not only give the FDIC a finger on the information pulse, but it would also give the deposit insurer a say in overall banking regulatory policy, including examination policies, procedures, and training. Such input is important to enable the deposit insurer to monitor risks in the banking and thrift system through the insurance funds.

Finally, with respect to the information requirements, the FDIC would need to retain meaningful backup authority to examine any insured institution. Backup examination authority enables the

FDIC to better assess the risks posed to the insurance funds, to verify information in reports and records, to monitor troubled and potentially troubled institutions, and to assess the condition of institutions experiencing unexpected changes in circumstances. I believe that this authority has been exercised in ways that are not duplicative or unduly burdensome to insured institutions.

The fourth category of authorities the FDIC would need concerns enforcement. Although it would not be a primary regulator, the FDIC would need to retain its enforcement powers. For example, the agency could continue to have authority to approve or disapprove applications for deposit insurance, and to terminate the insured status of an institution if the institution poses a threat to its insurance fund.

Retention of the FDIC's prompt corrective action authority under section 38 of the Federal Deposit Insurance Act also would be important.

The final category in the list of what the FDIC would need as an independent insurer under regulatory consolidation is resolutions authority. The current range of supervisory options regarding failed and failing institutions should remain.

Before concluding, I would like to say a few words about the dual banking system and the FDIC's relationship to it. From the Nation's founding, the States have had a role in bank regulation and supervision. Significant banking innovations have blossomed under the auspices of State authorities. The result has been a vibrant, healthy banking system.

Regulatory consolidation achieved at the expense of innovation would be unfortunate. The FDIC currently exercises the power to rule on the permissibility of activities of State-chartered banks. With this authority the Congress gave the FDIC in the FDICIA Act, the FDIC has been able to balance innovation and any risks to the insurance fund.

If this authority were transferred to the proposed Federal Banking Commission, all of the authority to determine the powers of banking organizations in a changing world would rest with one Federal Government body, the Commission. The important innovative character of the dual banking system would be compromised. Consequently, leaving the authority to rule on the permissibility of the activities of State banks with the FDIC seems to be advisable.

To summarize my testimony, the FDIC favors consolidation of the bank and thrift regulatory system. Consolidation could eliminate some of the unnecessary complexities that have developed. In pursuing the goal of a more efficient regulatory scheme, however, we should be careful to preserve the good parts of the current structure.

One essential feature of the current structure is the independence of the deposit insurer. It is most imperative that we avoid compromising the effectiveness of the deposit insurance program. For 60 years, Federal deposit insurance has been a fundamental component of a largely successful bank oversight structure.

Thank you. I look forward to answering your questions.

Senator SARBANES [Presiding]. Thank you very much, Mr. Hove. We appreciate your testimony.

Mr. Fiechter, we'd be happy to hear from you.

STATEMENT OF JONATHAN L. FIECHTER, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION, WASHINGTON, DC

Mr. FIECHTER. Thank you. I'll try to be short.

I appreciate the opportunity to present the views of the Office of Thrift Supervision on this important proposal. The objective of our regulatory system should be to preserve safety and soundness while avoiding placing unnecessary burdens on regulated institutions or stifling innovation.

I suggest in my written testimony three simple principles for measuring the extent to which our current system, or any proposed alternative, meets these objectives.

The first principle is efficiency. Does the regulatory system avoid overlap and duplication? Does it allow for early identification and rapid response to problems? Is the system flexible and open to innovation?

The second principle is effectiveness. Does the regulatory system have adequate resources? Is it able to attract and retain competent supervisory staff?

The third principle is the separation of core functions. Is regulatory responsibility allocated in a manner that avoids systemic conflicts that may compromise safety and soundness or other regulatory objectives?

In my statement today, I would like to summarize why I believe our current regulatory system fares poorly under this three-part test, and to explain why I believe agency consolidation would produce substantial benefits in each of these areas.

The first of the three key standards is efficiency. At present, there is significant redundancy in many of the tasks performed by the four Federal bank and thrift regulatory agencies. Each of the four agencies maintain separate administrative and legal support systems. Each of the four agencies maintain their own separate regulations, policies, procedures, and expertise in key regulatory areas that do not vary by charter type. These areas include capital, asset reviews, accounting, transactions with affiliates, lending limits, appraisal standards, and consumer protection.

Under our current regulatory system, a single group of affiliated financial institutions can end up being supervised and examined by two, three, or sometimes even four of the Federal bank and thrift regulators. Consolidation would eliminate these redundancies at the Federal level.

The efficiency of our current system is also substantially hindered by regulatory gridlock. In an effort to maintain some level of consistency, the four agencies consult extensively before most major regulatory initiatives, even when uniform rules have not been congressionally mandated. However, building consensus frequently takes months, sometimes even years.

Let me offer an example. In the summer of 1989, the four bank and thrift regulatory agencies formed a working group to develop common rules to govern the capital treatment of recourse obligations. This was an important safety and soundness initiative because banks and thrifts regularly engage in billions of dollars of recourse transactions.

Under existing capital rules, various forms of recourse transactions that present the same level of economic risk get very dif-

ferent capital treatment. Notwithstanding the importance of this issue, the interagency working group took a full year to agree on the wording of an advanced notice of proposed rulemaking that merely announced the issues under consideration.

Thereafter, it took another 3½ years, until December 1993, for the interagency group to reach agreement on a proposed regulation. Thus, almost 5 years have passed and the agencies are still at the proposal stage. No final rulemaking is anywhere in sight.

The problem with this interagency process is not the people who have staffed the interagency committees. These people have worked extremely hard and long hours to reach consensus. The problem is with the cumbersomeness of the process.

This is no way to regulate a financial system where there are frequent changes that require rapid responses. When changes in regulatory policy are needed to respond to new market innovations, or to threats to safety and soundness, neither institutions nor taxpayers can afford to wait years or even months for regulatory action.

Creation of a single safety and soundness regulator will put an end to this cumbersome resource-intensive process of interagency policymaking.

The efficiency of our current regulatory system is also adversely affected by the inconsistencies that inevitably arise when there are four separate Federal regulators.

Despite efforts at interagency coordination, numerous differences still exist in the regulatory approaches of the four agencies. These differences can affect the ability of banks and thrifts to compete on a level playing field.

Mr. Chairman, if we are to have a sound and competitive depository system, we need to eliminate the inconsistency, gridlock, and redundancy that are undermining the efficiency of our current regulatory system. Consolidation will do this.

The second of the three key standards I have suggested for evaluating the current regulatory system and any new system is effectiveness.

It is impossible to have an effective regulatory system unless the agencies administering that system have adequate funding and are able to recruit and retain well-trained professionals.

If the current regulatory system is left in place, I am concerned that the effectiveness of the OTS may eventually be compromised. Let me explain why.

Since the OTS was established in 1989, thrift industry assets have declined by 37 percent. Initially, the shrinkage was due to thrift closings. More recently, the shrinkage has been caused by charter flips. In the last 2 years, 242 OTS-supervised thrifts, or over 10 percent of the industry we supervise, have changed their charters primarily to State savings banks.

OTS has responded to this phenomenon by reducing its staff by 44 percent over the past 4½ years. Additional staff reductions will be required if shrinkage of the thrift industry continues. Unless something changes, OTS faces a prolonged period of indefinite, continuous downsizing.

Companies or agencies faced with indefinite downsizing must either consolidate or go out of business. Surviving as a stand-alone

organization, under such circumstances, becomes virtually impossible because the best people in the organization eventually give up hope and leave. This could cause significant quality control problems. Let me offer a practical example of this situation.

The OTS recently promulgated rules implementing Congress' mandate to regulate interest rate risk. This represents a significant advance in our safety and soundness regulation. However, our ability to follow through and effectively supervise this new program could be in jeopardy.

Over the past 24 months, the OTS has lost several of its key interest rate risk experts. To date, our efforts to hire qualified replacements have been unsuccessful. Candidates have expressed concern regarding the future of OTS.

If we lose one or two more people in this highly specialized area, we may not have the necessary expertise to implement our interest rate risk program effectively. This is just one example that could be repeated in a number of areas. Successful supervision of sophisticated financial institutions requires a core of highly skilled staff. Staff with these kinds of marketable skills are understandably reluctant to stay at, or accept new positions with, an agency that can offer them no assurance, even in the short term, that they will continue to have jobs.

We cannot afford a repeat of the mid-1980's scenario of a weak, understaffed thrift supervisory effort that was a factor in the thrift debacle.

Consolidation of the supervisory resources of the four Federal bank and thrift agencies into a single Federal Banking Commission would solve this problem.

In conclusion, I support the consolidation of the four banking and thrift agencies. A consolidated agency will not be a panacea for the many problems facing this country's depository institutions. But I believe it is a critical first step toward addressing these problems. Consolidation will make our regulatory system more efficient and effective. It will therefore provide a better mechanism for dealing with the complex issues facing our institutions.

Thank you.

The CHAIRMAN. Thank you very much.

I want to move through some questions here. Mr. Ludwig, let me start with you.

Who today has the authority to regulate derivatives and the impact that they may have on our banking and financial structure?

Mr. LUDWIG. I think each of us shares part of that responsibility.

The CHAIRMAN. Is there a single approach that you all follow?

Mr. LUDWIG. No.

The CHAIRMAN. Shouldn't there be?

Mr. LUDWIG. That is the strength of the single regulator approach. Derivatives are a growing and serious market. We all have good quality people, but they go off in different directions, and we have no agreed-upon approach.

The CHAIRMAN. Am I correct in understanding—I know you, Chairman Greenspan, have expressed to me your view that probably 80 percent of the issues have been resolved and about 20 percent of the issues on consolidation remain outstanding. Is that a fair estimation?

Chairman GREENSPAN. I'm using that as an order of magnitude. As I've indicated in my prepared testimony, we agree with a good number of the issues that Gene Ludwig and my other colleagues raise with respect to the question of where the real difficulties in multiple regulators are.

We do think that we ought to reduce the number. The interesting question is how much do you gain by going from four regulators to two, and how much from two to one?

It's not an arithmetical difference, it's an issue of far more complexity than that. Going from four to two is a tremendous reduction in the elements of combinations of different types of positions which people can have.

Certainly going from two to one does improve the structure. If you have a single decisionmaker, there's no question that it is, from a managerial point of view, better than two. But, our concern is, to gain that unquestioned managerial efficiency has very significant public policy costs which we think far override any perceived benefits which may arrive from going from two to one.

The CHAIRMAN. I understand that. You made that clear in your statement. But, I take it then, that in terms of the process of trying to reconcile all these issues, about 80 percent has been resolved and 20 percent remain?

Chairman GREENSPAN. Well, obviously, it depends on how you weigh various things. But you asked me, do we agree on most of the issues? The answer is we do.

The CHAIRMAN. Where would you put it, Mr. Ludwig? Is it about an 80/20 resolved/unresolved split at this point?

Mr. LUDWIG. That's optimistic. I think we share a number of common objectives, and I would say the majority are shared. I have a deep respect for the Fed and its independence. The Administration, even at the beginning of this process, made it very clear that the Fed should have a continuing role in the supervisory process.

I think we do genuinely agree. I have a tremendous amount of respect for Alan Greenspan and the other Fed Governors. They are terrifically able people, and the Fed staff is superb. We do agree on more than we don't agree on.

The CHAIRMAN. Let me tell you what I think we ought to try to do here. It looks to me as if it is about 80/20. I've even heard that today from you, in addition to this exchange, and I think an effort ought to be made, over the next week or so, to see if we can't resolve the remaining 20.

The fact that we've come most of the way, I think, is significant, I think it's positive, and I think we ought to try to work out and resolve the rest of the issues.

I would ask you, Chairman Greenspan, if you would take the lead for the Fed and see if that can't be done and not delegate this. And the same thing, I want to make sure that the Administration—and I'll speak to the Treasury Secretary—could see if we can't resolve the issue satisfactorily with both parties. I think that's important to try to do here. I would hope that can be done.

I think if we can gain the advantages that we've all enumerated and that we're seeking here and avoid unintended negative consequences, that would be a very positive gain. We're in a legislative window situation here where we've got health care, which is an

enormously complex and time-consuming issue. That's in the Finance Committee. I happen to serve over there as Chairman of that Health Subcommittee, and I'm very mindful of what's involved there, and we've got a whole host of other issues.

Timing becomes very important here. If we just end up in an endless hair-pulling operation, we can miss the opportunity to take the kind of positive step here that we need to take.

The fact that we don't have a common regime in place on derivatives alone, if we had to have one compelling argument for getting past this log jam and getting this reconciled, it's that. I know if we spent the time talking about it, there's four different approaches here as to how that's being done. I'm not confident that any one of the four is adequate, let alone the four taken together.

So that, to me, is an example of the kind of problem that happens. Now, we can have four people here, or we can have eight people here. Frankly, the logic that I heard Chairman Greenspan—and I tried to apply it to the SEC in terms of the question of whether you have to have two people in the same game, in effect, to get a lot of substantive advantages.

I thought about the Securities and Exchange Commission in terms of the equity markets. We're thought of as having probably the most vibrant, innovative equity markets in the whole world. In many ways, they're the envy of the world.

We've done that with a single regulator. Although, if you would apply the logic that's embedded in your presentation, you'd say to yourself, well, we'd better have two SEC's. We'd better just go and create a second one because if we don't have that creative tension, if we can't let people out there in the equity market shop back and forth in terms of who they want to be regulated by, we're going to miss something.

I don't think the experience there bears that out. I think what has happened has been that we've had a single point of decision-making and authority in that area. I think it's worked quite well. I think decisions do get made.

Rather than it being a dead hand in an area in which they have that authority, I think the results have been very impressive. I don't say they've been perfect. These processes never work that way.

But, when you start going down the road of saying, well, we've got to have two, and, of course, the Fed's position is they have to be one of the two, and I understand that. I understand the point that's being made there.

Stepping out of the Fed and looking at the question in these important areas of regulation, of whether you have to have two, or one, or six, or 25, I'm hard-pressed to see why there is some particular magic in two, as opposed to one, that's functioning properly.

And the SEC, it seems to me, is an example of one that appears to have done that quite well, and that we've not lost something in terms of the kind of flexibility and opportunity for innovation and advance that looks to me to be quite impressive.

Chairman GREENSPAN. Mr. Chairman, let me respond to that in several ways.

First of all, the structure of supervision and regulation within the securities business is a lot more complex than merely what the SEC does, which is the major rulemaker of a certain umbrella type.

The actual supervision and regulation, examination, and many of the other authorities which exist within the securities business is done by the self-regulatory organizations. The New York Stock Exchange does the examinations, the American Stock Exchange, the National Association of Securities Dealers, and a number of other areas of the industry actually do a good deal of that type of activity which we're referring to.

And, indeed there is a competitive tension that exists there, that is, which organization one joins or what aspect of the securities business one is involved with is determined, in part, by the form of the supervision and regulation at the lower level below the Securities and Exchange Commission which has an essential rulemaking area.

But, let me say to a much broader question, that I'm not saying that, of necessity, it is better to have two regulators than one in all areas of Government regulation. For example, the Federal Communications Commission, which distributes a band, cannot, obviously, be competed with by somebody else.

Similarly, there are activities, for example, in our case where there cannot be more than one monetary policy per economy. There are certain natural monopolies which do exist in supervision and regulation.

It does not exist in bank supervision and regulation, and there are advantages from the competitive tension which exists in supervision and regulation. In my judgment, they've served us well over the years. And, to essentially eliminate them, when they are of value, strikes me as not a particularly useful activity.

The CHAIRMAN. Are they providing us a value in understanding, supervising, and regulating, from a bank regulatory point of view, derivatives?

Chairman GREENSPAN. The issue of derivatives is a very interesting one. I'm surprised you didn't raise the other issue which is the fact that we have got the so-called working group, which includes ourselves, the Treasury Department, the Securities and Exchange Commission, and the Federal Reserve Bank of New York, which is working on it.

The CHAIRMAN. Let me just stop you there. I'm sure you heard what Mr. Fiechter said earlier. You've been around this game as long as anybody. You're as skilled at it as anybody.

When these things get delegated to these groups, these groups can go round and round for years, and, in fact, decades, and I would say to you, and the record in the future will bear out what happens, I am very much concerned about the derivatives market.

I don't think our regulatory apparatus today is sufficient. I think this issue is rattling around in a groping process, and, frankly, I'd be less concerned if the Fed could come in here and say, look, we understand this problem, we're on top of it. I don't think you're prepared to say that.

Chairman GREENSPAN. No, we're not. And I think there's an important reason why we are not.

This is an issue which all of us have been expending a very considerable amount of time and effort on. And the reason is, it's a clearly major issue with respect to the structure of finance generally, and banking particularly. Because, as you know, the dealers in this area, and, indeed, even some of the users, are very major players within the banking fraternity.

We don't yet know enough about the extraordinary details that are evolving how this is working to get a fixed single regulatory structure.

I am spending a considerable amount of my time on focusing on this issue; so are my colleagues. So is Gene Ludwig, who has done a considerable amount of work in this area. So are the people in some of the other agencies. It's far more important that we get it right than we just do it, because this is a very important part of our financial system which has some valuable aspects to reducing overall risk in the financial system.

Basically, we want to make certain that we don't inhibit the rational expansion of these particular products, but we want to understand precisely where the various touchstones of systemic risk are.

Frankly, until we are reasonably certain that we know that—and we don't know that at this particular point—it would be a major mistake to lock into a regulatory structure. I grant you that over the years, some of the deliberations—I mean, Jonathan Fiechter has raised some issues which I have tremendous sympathy for. It's a frustrating process which goes on which I think can be very materially improved.

But we have to look at the other side of it. That merely getting a single regulation because it is efficient and seemingly managerially correct can, in the financial business, be extraordinarily debilitating, and we've got to be careful about it.

The CHAIRMAN. Well, it can cut two ways, with all due respect.

We couldn't get a common approach on real estate investment by financial institution's looking back in time. We couldn't do that on foreign lending, either. We had big crises grow up in those sectors.

So, it isn't just derivatives. I mean, if we had a splendid track record that was the predicate leading into today's hearing, we'd have a different story. But, you know as well as I do, we've had other situations where these differences of interpretation, and standards, and in some cases, an absence of standards, have cost us dearly.

We've got to find a way to do a better job, and I think the experience that you and others at this table have accumulated over many decades, can help us do this. I think if we're too rigid and there's too much turf consciousness, and I'm not accusing you of that, but I think the Fed has those tendencies, just like any other organization does, including this one, then it becomes impossible to create an institution that will serve the public well.

Chairman GREENSPAN. I agree with that.

The CHAIRMAN. I don't want that to impede our ability to get to something here that can work better and would have worked better on commercial real estate loans, would have worked better on foreign lending loans, and will work better on derivatives. I think

we're in a risk position that the past bears out here by this fractured structure.

And it'll catch us again. It may or may not be on your watch. But I think it's time to do something to prevent it, and I trust that you're prepared to lead the Fed over the next week or so, in closing the remaining distance.

Chairman GREENSPAN. Let me just repeat, when I said to you it was 80/20, I said the 20 was going to be tough.

The CHAIRMAN. I understand that.

Chairman GREENSPAN. I don't want to go——

The CHAIRMAN. That's why I'd like you to lead the effort on the Fed side because I think we need a tough guy to work through a tough problem.

Chairman GREENSPAN. I appreciate what I think was a compliment.

The CHAIRMAN. It is a compliment.

[Laughter.]

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, I've just had an opportunity, and staff has just called to my attention that section 304, page 21 of the Administration's new proposal would limit all litigation that would be conducted, would be conducted only with the prior consent of the Attorney General of the United States and subject to the Attorney General's direction and control.

I think we have to get some historical perspective. Currently, the Office of Thrift Supervision has independent litigation authority. It decides who and when to sue.

The FDIC has the same authority with respect to liquidations, but not other suits.

The Federal Reserve Board has worked out an agreement with the Justice Department on its ability to bring suits in court.

If, indeed, this legislation is passed in this manner—well, let me first serve notice. I would vigorously, vigorously oppose giving to the Justice Department this total authority as to bringing the direction and control of litigation, absolutely. There's just no way, absolutely no way that I would approve this.

I just see this now. Here we're starting out with a fresh new agency, a new system, we're going to ensure independence from political influence, and we should allow the agency to make its determination as to when and how to bring suit.

I've not raised this with you, Mr. Chairman, because this has just been pointed out to me now. But I have to tell you there's no way this Senator will go forward with that provision, and I think the Administration had better get its ducks in a row.

This is the last—the last thing we need to do now is to say that we're going to give the Justice Department—and I have to say, and some people may be critical—I'm rather critical of the way they're running that place. I have absolutely no confidence in them. We've got Mr. Hubbell and company up over his head, and now they're going to be deciding when, how, and if to bring suit.

Let me tell you something else. None of the—the Fed people did not point this out. This has just been pointed out to me, literally, 10–15 minutes ago, so I assure you I would have shared this with

you and with Senator Shelby who I was speaking to before about this.

My one question that I was going to raise is, would you continue, Mr. Greenspan, your negotiations with the Administration to see if you can't begin to eliminate some of the impediments and some of the problems that you still feel exist, with both of you working cooperatively?

That was my statement and question to you.

But this has been pointed out to me, and I just have to say, very, very strongly that this is a non-starter as far as this Senator is concerned. To date, I have not said to the Fed, or through staff, or to the Administration, or to the Treasury people through staff or directly or indirectly, what I thought had to be. I thought the various parties should be working on this.

This section 304, giving to the Justice Department total discretion when to bring suits, in this case is, as far as I'm concerned, an overreaching, and I have to tell you maybe it's paranoia on my part. But, given the record to date, of the abuse of authority, I would say absolutely no way, no way. And I would do everything and anything possible to see that this bill be defeated unless this provision is taken out.

I'm not going to start a new, or try to get efficiencies, an independent—imagine, you'd have to go running over to the Justice Department every time to find out, maybe, even when you could bring an investigation. What's the sense if you have to then check with them to find out whether you can commence a suit?

That's just wrong, that's wrong. I don't know how that came in there. It wasn't in the initial proposal, but it finds its way in there, and I am deeply distressed about it, and I have to share that with you publicly.

The CHAIRMAN. Let me just say, Senator D'Amato, I think we need to have a response to that. I look at that and that doesn't appeal to me either.

Mr. LUDWIG. What is contemplated here and what has been agreed to with Justice is a memorandum of understanding.

Senator D'AMATO. I wouldn't care if Justice agreed with you. Did Hubbell write it himself?

[Laughter.]

What are we kidding?

Mr. LUDWIG. The Fed's and the new FBC litigating authority, from a statutory perspective, would be roughly parallel. The Fed has an agreement with Justice as to litigation, and in our situation at the OCC, we are in much the same situation.

The CHAIRMAN. But today, don't you have authority to proceed on your own if you decide to do so?

Mr. LUDWIG. We do not.

The CHAIRMAN. None whatsoever?

Mr. LUDWIG. We do not.

The CHAIRMAN. Does the Fed have authority?

Chairman GREENSPAN. To proceed in what areas?

The CHAIRMAN. It says any litigation that you want to bring. Do you have to bring litigation with the approval of the Attorney General?

Chairman GREENSPAN. The General Counsel tells me we at the Reserve Board are in the same position that the Comptroller is. The Reserve Banks, however, can bring individual actions on their own accounts.

The CHAIRMAN. So, if you're going to bring any litigation, you have to coordinate and get a sign-off from the Justice Department, or do you just inform them?

Chairman GREENSPAN. The Board of Governors is in the same position, with respect to litigation in this area, as the Comptroller.

The CHAIRMAN. I guess I'm not clear. Maybe I'm not making myself clear.

Chairman GREENSPAN. They act as our attorney.

The CHAIRMAN. But does that mean that you can make your own decision as to what actions to undertake? I mean, if you decide to undertake an action, they then act as your attorney. But, do you make the decision unilaterally as to proceed?

Chairman GREENSPAN. Yes.

The CHAIRMAN. You do?

Chairman GREENSPAN. Yes.

The CHAIRMAN. And do you at the present time, Mr. Ludwig?

Mr. LUDWIG. We do only in very limited areas.

The CHAIRMAN. But, you do have some authority in that area?

Mr. LUDWIG. Some limited authority.

The CHAIRMAN. What about the other two?

Mr. FIECHTER. We do have authority to take action.

Senator D'AMATO. Independently?

Mr. FIECHTER. Yes.

Senator D'AMATO. Absolutely. Mr. Chairman, that's what's got this Senator absolutely—this is absolutely not acceptable. I mean, I've just seen it now for the first time. You've never heard me say something like that from here as it relates, but sometimes you've got to lay down a marker and say there's no way.

I just took my arm out of the sling.

[Laughter.]

And I'll be back visiting the Doc again.

Absolutely no way.

Mr. Ludwig, how did this come in? When did you put this provision in?

Mr. LUDWIG. The bill is the result of an interagency effort which included Justice.

Senator D'AMATO. But this is a new one, this provision here? They just added it, right?

Mr. LUDWIG. Senator, the bill was not presented until yesterday. While the proposal was enunciated by the Secretary in terms of its major provisions, it didn't come up as a piece of legislation until yesterday.

Senator D'AMATO. The part about that interagency, the Justice Department put this in. I guess they don't have enough to do.

The CHAIRMAN. Having had only a quick reading of it, I must concur with Senator D'Amato, it ought not to be in there.

I'm willing to listen to the arguments, but if we're going to have an independent banking commission, this language certainly raises questions in my mind. So let's have you take a look at it.

Senator Shelby.

Excuse me, did you want to make a comment?

Senator D'AMATO. No, thank you.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Mr. Chairman, thank you.

My arm hasn't been in a sling, and I hope it won't be at the end of the day.

Chairman Greenspan, I applaud the role of the Fed. I believe that the American people have a lot of confidence in the Fed. Is the Fed perfect? Absolutely not. Are their judgments always perfect? Absolutely not. But isn't there a way, that you were talking about earlier, to consolidate a lot of this duplication here without weakening the role of the Fed?

I think this is going to be one of the central questions here. Are we going to do something because there's a so-called legislative window, a political window? Are we going to do something hastily that we might regret? Are we going to consolidate some of these duplications that we could do away with, and yet retain the central role of the Fed? Would you like to sum up some of your proposals again succinctly?

Chairman GREENSPAN. Senator, I think that we have gone through the whole question of the nature of supervision and regulation in some very considerable detail over the years. And, obviously, we have been viewing the issue with a renewed sense, trying to see where and what parts of the Administration's proposal we find useful, innovative, and capable of supporting.

As I said in my prepared testimony, I think that reform is required. There has been a gerry-built structure of supervision and regulation which I find, strangely enough, works better than it probably should, if you look at the way it was built up.

But, nonetheless, there is an element of duplication which is more of a form of permutation and combination, when you go from one, two, three, four, than just the arithmetic or even the geometric change. When you get up to four Federal regulators, it really multiplies all of the complexity, if you need unanimity, as we do on a number of questions with respect to certain types of rulemaking.

In my judgment, if you curtail it from four to two, you pick up far more than half—you eliminate far more than half the excess. And I think a two-regulator system, while clearly not as managerially efficient as the single one, is a major reduction in effort.

Senator SHELBY. It's a big step, isn't it?

Chairman GREENSPAN. It's a very big step. But there's also a very important issue.

It's not clear to me from other than a managerial aspect, looking strictly at the issue of supervision and regulation and not to monetary policy or systemic risk or the like, it's not clear to me that one is better than two. In the sense that we often find that, when you have individuals negotiating, you come up with a better idea, and it's important to us specifically when we recognize, in our deliberations with our colleagues, that we, of necessity, have to bring, as I indicated in my opening remarks, an economic perspective to the process.

And the process, basically, has got to be one in which we have to take the statute given to us by the Congress, try to get a sense, as best we can, of what the underlying purposes of the Congress

were with respect to a particular piece of legislation, and try to write rules which, while capturing that particular general notion, do not inadvertently hobble the bank with forms of regulation which makes it difficult for them to engage in the type of prudent risk-taking that we think is an essential ingredient for the financial system and for the economy as a whole.

So, while I am attracted to the notion of having a single person say, this is it, the "this is it" may not be the right answer. And I, frankly, would be a good deal more comfortable with a process in which you had two people, two groups, two organizations coming together.

It's a check and balance. It will take longer. I do not deny that. It's part of the process, but I, frankly, suspect it may be better public policy.

Senator SHELBY. Do you think that the strength of our financial systems are more important than something taking just a little longer?

Chairman GREENSPAN. I think it's incumbent upon those of us at the Federal Reserve who have been involved in this to try to make available to the Congress as much of the detail and our concerns about what various different changes in legislation will do.

One thing I do think we have to be careful about is to make certain whatever it is we do, we get it right, and while I happen to agree with the Chairman, I think that there is a certain window that exists, and partly with what Gene Ludwig said, namely, that banks are doing well, the system's doing well, and we don't have extraneous concerns with respect to the structure of banking that we have to be considerate of at this particular moment that we would have at other times.

That is not the same thing as saying that we should be acting hastily or without fully thinking through the implications, which could be quite profound if we go in the wrong direction.

Senator SHELBY. Mr. Chairman, I believe that you realize there's a lot of support in the House and the Senate for retaining the central role that the Fed plays in the banking system. I hope, when you consider how we can go from the so-called, that 20 percentage, or whatever it is, that you won't give that away.

Thank you.

The CHAIRMAN. Thank you, Senator Shelby.

Senator Bennett.

OPENING COMMENTS OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

Mr. Ludwig, I listened to your testimony and found myself getting more and more uneasy, which I know is not what you intended. But you remind me of an axiom in the business world which is, when you've made the sale, shut up. And this Administration has made the sale that we need some kind of consolidation.

Now the Administration should shut up and get to a discussion of what kind of consolidation, rather than continually beating us over the head with how terrible the present circumstance is. Because everybody agrees how terrible the present circumstance is. You've made that sale.

The issue that I think we're confronted with, which I had hoped we would get here, would be do we do it the way Treasury wants to do it, Secretary Bentsen wants to do it, you want to do it, or do we do it the way the Fed wants to do it?

Chairman Greenspan responded, I think, to that political dynamic by giving us rather specific recommendations of the way to do it. Merge the OCC and the OTS. Remove the FDIC from examining health and so on. There are a series of bullet points here with a specific plan, in Chairman Greenspan's point of view, which I found lacking in yours, other than a cheerleading for we've got to clean up the present system, and then at the end, a simple statement that the Administration bill does it, without the kinds of specific things that we have here.

I would hope you would, you and your allies in the Administration who are in favor of the Administration's bill, come back to us, probably in written form, because I don't know that we're going to have any more hearings on it, but with a recognition that the need to change is a given, and let's have no more cheerleading on how terrible the present system is, but some rather hard and specific statements as to why your proposal is better than the Fed's.

And why some of the things the Fed is insisting it must have, don't make sense, instead of trying to bury us with the assumption that if we stand with the Fed, we're somehow standing for the present circumstance.

I am, on the basis of what I have heard, prepared, if a vote were to come today, to vote with the Fed. And say, let's adopt those proposals that Chairman Greenspan has given us here, because I've heard no compelling reason from the Administration, in any specificity, as to why the Fed's ideas are not good ideas.

Instead, I have heard, oh, we need to fix the system. So I won't try to overmake the sale. I think I've made the point. But, I would hope you would take that message back to the Administration, in your role here as the chief cheerleader for the Administration's position, that the time has come to stop talking about the severity of the problem and start getting into the nuts and bolts of why one proposal is better than another.

Mr. LUDWIG. I'd be prepared to answer that now, if you'd like.

Senator BENNETT. I'd be delighted, yes.

Mr. LUDWIG. There are several reasons why the approach the Administration is taking is the best possible approach.

First, it is unfair to call it a monolithic system. It is, indeed, in its basics, a system of checks and balances. The FDIC would retain its independence, its backup enforcement authority. The FDIC would be an independent force, or if you will, a check on and a dynamic tension with the supervisor. The Fed also would retain its independence and its focus on monetary policy. In other words, you would have the FDIC focusing on the critical role of deposit insurance and liquidation, its core mission, and the Fed focusing on its core role, monetary policy.

The Fed would have complete independence on the payments system and the discount window. Its key role in the economy would be retained. Moreover, in terms of its concern about hands-on supervision, the Administration's proposal has a variety of different tensions built in that give the Fed some very significant authority

in the banking supervision area. First, it would have a Board seat on the new FBC. Second, it would, in any year, have the opportunity to examine 35 percent of the entire banking system. This would actually increase the Fed's role in supervision. Right now, the Fed examines about 15 percent of the banking institutions, in terms of assets, and it does not examine the lion's share of the largest institutions.

The Administration's proposal would allow the Fed to select those institutions for which it wants to take a lead role, so that it would be leading the examination group in that sizable percentage of institutions. It would not be limited to the largest institutions, it would have a portion of the smaller institutions it could select from to know what is going on around the country. Now that is actually an increase in its authority.

The fundamental notion of the Administration's position is not a monolithic approach, but rather one of three legs to a supervision stool: the independent Fed, the independent supervisory mechanism, and the independent FDIC with its insurance and backup. I can go into this in greater detail, but I don't want to overmake the sale, and I'd be happy to meet with you privately.

Senator BENNETT. OK. I'd like to have you do that. If we could, now that you've told us that the Fed role would be expanded and the Fed would be far better off under the Administration position, let me ask Chairman Greenspan if Mr. Ludwig has made that sale as far as you're concerned. Do you feel better off now that you've had that explained to you?

Chairman GREENSPAN. Not really, Senator.

[Laughter.]

First of all, I think it's 20 percent. And it's the State member bank assets, as a percent of total banking assets, that you're probably using.

There are two basic authorities which we consider to be crucial to the issue of our authorities.

The first, and indeed the most important, which has not been discussed here at all, is the fact that we supervise and regulate all the holding companies which have, on a consolidated basis, more than 90 percent of the total banking assets in the system. But, it's the rulemaking process, which includes applications and capital and a variety of other subsidiary issues, which gives the Federal Reserve the supervisory clout and the ability in periods of crisis to go into various major banking institutions and to know that we can have a major influence.

The issue of the number of banks we examine—which is a wholly different question from the bank holding company supervision and regulation and especially rulemaking question—is largely for purposes of our getting a general judgment about the nature of the banking system, and that is more related to the issue of our knowledge base which spills over into monetary policy.

We don't need to have a major extension of presence in the number of banks or the proportion of assets which we currently examine. In my judgment, the particular mix is certainly sufficient for our purposes. Whether it's necessary, I'm not certain.

I can imagine slight changes here and there which could not affect, in any conceivable manner, in my judgment, what it is we're

picking out of the banking system. For example, we don't need to have major national banks if we have a set of large State member banks in learning, for example, how the derivative markets work. We are in a number of major State member banks which are dealers in the derivative markets, and we have learned, to a large extent, how that system works.

So, since we know, basically, how to evaluate derivatives in a national bank, because we have practice in the State member banks, we do have the capability of reading reports from the Comptroller and understand how it works, whereas, if we didn't have the hands-on examination capabilities within the State member banks, our ability to deal with written reports, and our ability to understand how the system works, would be materially impaired.

I think, when this discussion is going on about our authorities going up, it is very important in discussing the question of where the Federal Reserve's powers come from, to start with the bank holding companies. That's the crucial issue. That's where our major control of systemic risk lies.

The question of what proportion of banking assets we supervise is a wholly different question and does not directly relate to that issue. Obviously, to the extent that we learn how the various systems function in the larger banks through our major State member bank examinations, we know a great deal about the large banking systems and it is very helpful in understanding how systemic risk affects various different institutions. But, it's the holding company supervision, from which our crucial authority, capabilities, and clout come from in periods of crisis.

Senator BENNETT. And you wouldn't be reassured by having a seat on the Banking Commission?

Chairman GREENSPAN. I don't think that substitutes in any regard, Senator.

Mr. LUDWIG. If I might respond to two things, Senator.

First of all, a detailed proposal from the Administration came up yesterday. It is a legislative proposal which actually got us in trouble with Senator D'Amato.

Chairman GREENSPAN. I noticed.

Mr. LUDWIG. The Fed has worked hard and diligently. They have got several principles, but they do not have a full-blown legislative proposal. So, it is a little bit like comparing apples and oranges.

I think what Chairman Greenspan says about the importance of the Fed makes sense, and, as I said, we have tried to address that.

One thing on the holding company issue, which I think is very important to emphasize, is that these banking organizations operate along functional lines. There are nonbank subsidiaries in the holding company, holding companies themselves, and banks with functions which are quite parallel. So, when you are supervising and writing rules, there is not a clean distinction between what goes on at the holding company and what goes on at the bank. Consequently, one of the worries we have is what drops through the cracks, and there have been instances where we assumed things were being examined in the holding company and, in fact, they were not.

Banking institutions can switch back and forth where they put their assets in a lot of different important areas like, for example,

mortgage servicing, between the holding company and the banking subsidiary. Having a clean line of examination is very important for the safety of the system. I think that is a critical element of the Administration plan, that you can look from top to bottom, carefully, at all the assets in a banking organization and not simply look at a portion of the business in terms of trying to evaluate what is going on and supervise completely.

Senator BENNETT. Thank you.

Mr. Chairman, I think this is the kind of conversation that will be the most valuable to the Committee, as we hear what has boiled down to two basic proposals, two protagonists going at each other, and I think it's been useful to have this kind of exchange. I thank both Mr. Ludwig and Mr. Greenspan.

Chairman GREENSPAN. Did you want me to make one comment?

Senator BENNETT. Please.

Mr. LUDWIG. We're not going at each other. We're actually great friends.

The CHAIRMAN. I understand that, but, hopefully, we're reaching the golden mean here, coming together.

Chairman GREENSPAN. The issue that Gene Ludwig raises with respect to the functional relations and, more specifically, the integration of the lead banks and the holding companies is an important one.

That's the reason why one of the options we are talking about endeavors to address that question and tries to perceive the central line for the vast majority of banking organizations so that, indeed, there is a single regulator per banking organization for precisely that reason.

We, in our various different options, end up with a modest to small number of large institutions in which we are not able to do that with a single regulator. In our judgment, other things equal, you would have, say 25 or 30 institutions in which you'd end up with a holding company regulator, which would be the Fed, and the Federal Banking Commission doing all the banking organizations.

That is not as efficient as one doing the total. In order to create a seamless line, as Gene points out, in all institutions, you do need a single banking regulator. But the cost to public policy and to the financial system of that advantage—and it is an advantage—in my judgment, is just far too great.

I think in the balancing of public policy issues, which gets not only to the efficacy of supervision and regulation but the importance of the central bank in the structure of the financial system, we come down very strongly on the weighting of these pluses and minuses to argue that it is preferable to have a mild deficiency in this break, which, I think, can probably be made very minimal, rather than pay the cost in what I consider to be a major difficulty with the banking system and a number of other issues which would accrue from the single regulator.

The CHAIRMAN. That's one of the reasons why we want to talk to the bankers who are premier to monetary policy. They're not involved to the same degree with respect to regulatory activity, so there is an anomaly there that we ought to take a look at.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman.

Chairman Greenspan, I want to take as my text for the questions I want to put to you, a story that appeared in the New York Times on Saturday by Keith Bradshear and a story that appeared in the American Banker on December 21, 1993, by Jim McTeague.

Now the Bradshear story, last Saturday, headlined "Twelve Bankers Back Fed on Powers; Oppose Clinton for Regulatory Shift." I'm now quoting from the story:

> In a closed meeting with the Federal Reserve's top officials, a dozen of the Nation's most powerful bankers vowed to back the Fed in opposing the Clinton Administration's plan for centralizing banking regulation. The Chairmen of big banks in each of the Fed's twelve regional districts endorsed instead the Fed's plan to take over the bank supervision role of the Federal Deposit Insurance Corporation according to a copy of the meeting's official summary.

And later on in the story, it says:

> Unlike the minutes of the Fed's meetings on interest rate policy, which are released 6 weeks after each session, the summary of the Fed's quarterly meetings with bankers are not released publicly. The bank regulation section of the summary from the most recent meeting was obtained today from a person not at the Fed but sympathetic to it.
>
> Joseph R. Coyne, the Press Secretary for the Fed, declined to comment on the Council meeting.
>
> Treasury officials also declined to comment, saying that they did not have a copy of the Council's summary.
>
> Participants in the meeting also refused to discuss it.

And then they name a few of the participants.

I'm hopeful that here today we may be able to discuss it.

Now, to round out the premise of the questions, I now want to quote from the American Banker article back in December. This is talking about regulatory reform and also community reinvestment policy, covered in this article. It says, and I'm now quoting, these are things that are on the public record, which give me some concern. I want to examine them here this morning.

> The Fed endeared itself to the big banks December 10th, when some of its members declared they would sink the CRA plan if banks expressed their disapproval during the current comment period. 'I'm perfectly willing to tear it up, throw it into the fireplace, and go back and start all over again,' said Fed Governor Lawrence Lindsay.
>
> Some bankers tell me . . .

This is the article now:

> . . . Some bankers tell me that the Fed, in enlisting them to oppose the Administration's regulatory reform, cited that December 10th meeting, and suggested it was time for banks to return the favor.

Now, first of all, is the New York Times article about this meeting accurate? Would you care to comment about that?

Chairman GREENSPAN. This is the Federal Advisory Council, which is a statutory organization under the Federal Reserve Act, and goes back to the 1913 original Act, which requires us to consult with the representatives of the twelve Federal Reserve districts.

They come in periodically and we usually have a go around on a number of different issues of particular importance. My recollection of the meeting, and this is probably something which I'd much prefer to take a look at the notes that everyone had, was we discussed the types of things that are being discussed today. That is, the questions of what are the appropriate policies and, indeed, you're having the banking groups up tomorrow, are you not? You

can ask them. It's pretty much the same groups of people. What we have found in this regard is that the bankers, as Senator Murray said early on, are substantially in opposition to a single regulator, I suspect, but I'm not certain, for many of the reasons that I have in my testimony today.

We do discuss the various different issues, monetary policy, regulatory policies, and other things, any matters that the bankers or we wish to discuss.

I must say to you, I don't recall at any of those meetings the quote attributed to Governor Lindsay, and I very strongly reject the notion that we are not supporting the appropriate application of CRA, which we are statutorily obligated to implement.

We may have differing views as to the best way to do that. My own personal view is that the issue of discrimination is abominable, that I think it exists in lending practices. It was the Fed which, I think, found the smoking gun when our Federal Reserve Bank of Boston study showed how it was done, and we are very strongly supportive of maintaining an appropriate CRA presence.

We, at the Fed, have got a fairly large establishment which does that.

Senator SARBANES. Today and the American Banker, and I'm now quoting the article:

> A banking advisory group affiliated with the Federal Reserve has issued a report to top agency officials that it is highly critical of regulators' proposed reform of the Community Reinvestment Act.
>
> The Federal Advisory Council . . .

The same group that we've made reference to that was referred to on Saturday for opposing the regulatory changes.

> . . . the Federal Advisory Council twelve-member group representing big banks that advise the Fed on banking issues, recently called on regulators to refocus their proposal on a single element.

Has this Federal Advisory Council traditionally issued statements of this sort?

Chairman GREENSPAN. I don't ever recall such a thing existing. Are you sure that it's—I know it's in the newspaper. Did anyone check to see whether it's accurate?

Senator SARBANES. Well, I'm asking you. If it's not accurate, I think you ought to set the record straight. I mean, I'm working off the public record here.

Chairman GREENSPAN. No, no. I understand that.

Senator SARBANES. Of course, I'm not only working off the public record but the public is working off this public record.

[Laughter.]

And, therefore, if it's misplaced or inaccurate, we're depending on you to try to set it straight here this morning. That's in part why I'm putting the questions to you.

Chairman GREENSPAN. But, I have no knowledge—I'm aware of what the group does in the meetings that we have periodically, which I find, frankly, very useful to us because it gives us——

Senator SARBANES. It says the Federal Advisory Council laid out its concerns in a confidential statement to Fed officials after a February 11 meeting. Now, how are, do you have any knowledge of how all of this is being leaked?

Chairman GREENSPAN. I do not, Senator.

Senator SARBANES. The New York Times said that the regulatory thing was obtained from a person not at the Fed but sympathetic to it.

I want to go back to the December 21 article, and I'm just quoting the writing of the author of the article now:

> Some bankers tell me that the Fed, in enlisting them to oppose the Administration's regulatory reform, cited that December 10th meeting.

That's the meeting where, according to this article, the Fed endeared itself to the big banks when some of its members declared they would sink the CRA plan if banks expressed their disapproval during the current comment period. And it's there that the Lindsay quote appeared.

Chairman GREENSPAN. Let me say that, were we to do that, that would be wholly inappropriate. I'm not even sure whether there's a legal question in that. And we do not do that sort of thing. As far as I know, I've been in on those meetings. I would not allow such a discussion to go on.

The CHAIRMAN. But isn't this a remarkable juxtaposition? I mean, these stories are written by distinguished journalists writing in different places. And, the fact that all of this fits together, and you just said you can't recall another time when a statement like this has been put out, and you had the lead in to it in an earlier story. Do we scratch our heads at things like that?

Chairman GREENSPAN. Senator, let me just say one thing. The implication of that is that, basically, somehow we're trading off support from the banking community and some of our regulatory initiatives and views for having some form of tit-for-tat regulation on CRA. I would deny that completely, fully, unequivocally. I think, were that the case, it would be an absolute miscarriage of our appropriate policies.

Senator SARBANES. Are you making that denial as to yourself, personally, as the Chairman, or are you denying it for the entire Board of Governors?

Chairman GREENSPAN. I'm denying it for the Board of Governors.

Senator SARBANES. So you're assuming here the burden of asserting to us that nothing of that sort has transpired on the part of any members of the Board of Governors?

Chairman GREENSPAN. Well, you're asking me whether or not individual members may have said something in private to another individual? I, obviously, have no way of knowing that. What I do have the authority to do is to commit the Board of Governors. I am the Chief Executive Officer. No individual member can cut a deal, if you wish to put it that way. It would be most inappropriate.

Senator SARBANES. Let me ask you another, somewhat broader, question.

Is the Fed's ability to be the regulator of certain banks important to the Fed on occasion, when it wants to move in certain directions with respect to monetary policy, in enlisting the cooperation of the banks to do so?

Chairman GREENSPAN. You mean, to be very specific, if we, for example, were to reduce the Federal funds rate to try to induce them to lower the prime rate? I mean, is that the type of thing you're referring to?

Senator SARBANES. No. I'm thinking more of when you get an instability in the system and you're calling on the banks to come forward in order to tide it over.

You see——

Chairman GREENSPAN. The answer is yes, we do.

Senator SARBANES. Your role as a regulator is important then, in enlisting that cooperation from the banks?

Chairman GREENSPAN. Yes, Senator, it is. I think it's crucial.

Senator SARBANES. What about the problems that have been raised to us by some in the banking industry that they, in effect, go along because they feel that since you're their regulator, they have to play ball with you?

Chairman GREENSPAN. Well, now let me give you a very——

Senator SARBANES. Maybe they should have to play ball with you. I mean, I guess the counteranswer to that on your part is, look, we have a pressing crisis here. We want to take certain monetary action, and we're going to lean on these institutions in each and every way we can because we think they're very high stakes and we're going to, in effect, put the pressure on them to respond. But, you do get a mixing, in that instance, I would take it, of the straight regulatory role with a monetary policy rule, do you not?

Chairman GREENSPAN. You do, and—let me give you a very specific instance when, indeed, that was done.

The day after the stock market crash of October 1987, it's the day we injected a considerable amount of liquidity in the system and did everything which a central bank is supposed to do, as it says in the textbooks.

The really crucial issue, however, is that we became acutely aware that there was tremendous fear and uncertainty in the banking community and a prospective of freezing up of payments and activity because, for example, a typical bank makes huge numbers of payments earlier in the day, expecting large payments coming back later in the day, or, I should say, half of them are in that position.

There were a substantial number of large institutions who were very concerned about making payments on that following day, fearing that a number of the people who were scheduled to make payments back later in the day would not be solvent. And making the payments out in the morning, which essentially could very well be the size of their capital, could leave them at the end of the day insolvent.

We went into a number of those organizations to, in fact, indicate that it was in their rational self-interest to make those payments because if they failed, you would have the whole system seizing up, and it would be not only to everyone's detriment but, specifically, to theirs as well.

And the answer is yes, we do, and did go into those organizations under those conditions, because that is what a central bank is supposed to do when confronted with a crisis where there is a high degree of fear. We try to bring an element of rationality into the system.

In this particular case, it was crucially important to stabilizing the system.

Senator SARBANES. I guess the question I'm asking is not whether you tried to introduce an element of rationality into the system, and as you just put it, tried to make them see that it was in their rational self-interest to behave in a certain direction but whether, in addition, the dimension that you are their regulator enables you to apply a pressure upon them over and beyond the rational persuasion.

So they, in effect, say, well, you know, we're not persuaded rationally. We don't really agree but these people are our regulators and they can cause us a lot of grief if we don't go along on this thing, and so we better go along on this.

Chairman GREENSPAN. We stay on this side of threatening. We think threatening them, which we do not do, is inappropriate.

Senator SARBANES. A wink from you, Mr. Chairman, for many constitutes a threat, does it not? I mean, you don't have to threaten. You just have to say a few well-chosen comments?

Chairman GREENSPAN. I hope it's only a few.

Senator SARBANES. And I hope they're well-chosen too.

[Laughter.]

Chairman GREENSPAN. I've said about as much on this as I intend to.

The CHAIRMAN. Senator Bond.

OPENING COMMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you, Mr. Chairman.

My apologies to you, Mr. Chairman, and to the witnesses. We had a hearing in the Treasury Appropriations Committee where I'm a Ranking Member, and I had to be there and miss much of what I'm sure was interesting discussions.

Today, I have a statement that I would like to submit for the record.

The CHAIRMAN. Without objection, so ordered.

Senator BOND. I have read some of the statements and my able staff has tried to keep track of what questions have bee previously asked, but in case I miss, my apologies for duplicating any questions you've previously addressed.

Let me start off, Mr. Fiechter, the Office of Thrift Supervision is currently under stress and the number of institutions declining are reducing the assessment income. I assume that as your income goes down, the ability of OTS to function becomes more of a problem. If so, how are you handling it, and in this situation, even if we are not able to come up with a mutually agreed compromise that keeps everybody sullen but not rebellious, which we can get through the Congress, do you think it's possible that we should go ahead with the merger of the OTS and the OCC in any case?

Mr. FIECHTER. Let me treat that as two questions. First, how are we handling it, and then second, what might be a possible solution.

I think we're handling it reasonably well. It's a bit of a Chinese water torture, however, for the staff. The average cut in staff has been 12 percent a year. It was 17 percent in 1993, and to the extent that we continue to have institutions in recent years, for the most part, flipping to State charters, it is extremely difficult for me when a competent senior person comes up and says they've been offered a job elsewhere, and we try to convince them that they

should stay at OTS for any length of time, recognizing that they might have their job eliminated 18 months hence.

I think that, absent some change in the flow of institutions out of OTS, there really is a critical need to address the OTS problem.

The difficulty with a simple merger with the OCC, and not doing much other than that, is that many of the pressures that thrifts are facing, the OCC is also facing. To the extent that there is a very significant difference in the way the regulatory costs are distributed between Federal institutions and State institutions, the OCC is also beginning to experience a loss of Federal institutions since, under our current system, national banks and thrifts have to pay for their supervision. State member banks and nonmember banks get Federal supervision, in essence, free. There's no explicit charge for that.

That puts a tremendous pressure on institutions that the OCC and OTS supervise to leave. You might be taking what I consider a very large problem for OTS and merging it with another agency with a lesser problem. I don't know that you've solved—over the long term, that doesn't seem like much of a solution.

Senator BOND. Mr. Hove, I might ask you how you would respond to the testimony that suggests that it has been a conflict of interest for the FDIC to be both a regulator and an insurer. I gathered that from the OTS testimony.

Mr. HOVE. Our role as a regulator applies, specifically, as primary regulator of those banks that are State-chartered banks that are not members of the Federal Reserve System.

We have operated very well with those institutions, and, in fact, have a very skilled cadre of bank examiners that work very effectively for the FDIC. We have worked with State supervisors and have allowed the State supervisors in those States where they have certified examination staffs to do the examination in one year, and the examination in the other year is done by the FDIC.

This has worked very well. We have been able to conduct our examination responsibilities in those institutions very well, working with those States that now have certified examination staffs. There are about 30 States, I think, 29 or 30 States, that have certified examination staffs.

In the other institutions, we serve as a backup to the primary regulator. Our concern there is the safety and soundness of the institutions and the integrity of the insurance funds. As you know, the insurance funds were stressed very much. Our goal in the last couple of years has been to restore those funds. I think the FDIC has done a credible job in restoring those funds.

It is extremely important that we do continue that role as a backup to the primary regulator, whoever that primary regulator is, because we, in fact, are the last line of defense before the taxpayers get the bill.

It is important that we have all of these things that I outlined in my testimony—that we have the availability of information that will flow on all institutions, not just those that we were primary regulators of, but all institutions, that we have the information to ascertain what the risk to the insurance fund is. And that we can make sure that if we see risks, that we can identify those risks,

stop those risks, and have the ability to go in and prevent any big risks from happening.

Senator BOND. Under either the Treasury plan or the competing proposals from the Federal Reserve, you, by losing your primary regulatory function, lose some of the ability to perform the kinds of examinations necessary to ensure the safety and soundness, to perform your insurance protection role?

Mr. HOVE. We would lose that examination staff that we now have that conducts the examination in State-chartered nonmember banks. Those institutions would be taken away from us in either proposal.

Senator BOND. There isn't any overlap. Do you get any benefit in protecting the insurance fund from the expertise and the practical application of those examinations?

Mr. HOVE. Yes, we would. Certainly we would have the information available from either of these proposals, but we would need to retain the examination staff so that we could serve in the backup role that we now have and would continue to have. We would still need a supervisory staff that could look at all the examination reports.

We need to maintain the skill and expertise that we have in our supervisory staff so that they can look at examination reports intelligently and determine what the risks to specific institutions are, to assign the premium rates, to determine where there are problems that we've identified that perhaps the primary regulator has not identified. This is the balance that I think is needed.

Senator BOND. Mr. Ludwig, you say the single regulator, if it's an FDC, being able to do a better job of protecting consumer interests, being able to issue more consumer regulations, is this one of the things that the consolidated FDC would be able to do as a bank regulator.

Mr. LUDWIG. Well, sir, on the consumer side, I do think there is a huge benefit. Let me explain one of the key elements here.

Right now, all of the agencies get consumer complaints. We get about 15,000 complaints a year, but roughly 3,000 of those are sent to the OCC in error because consumers simply don't know which agency to complain to about a bank, and I don't blame them. I do not know whether you have seen the chart——

Senator BOND. Yes.

Mr. LUDWIG. —you've seen the chart outlining who regulates what. It's so complex even a skilled regulator would have trouble in the case of any given subsidiary figuring it out, let alone a consumer. So there is clearly a benefit to having one regulator. There's no doubt about that.

Senator BOND. How about the issuance of regulations?

Mr. LUDWIG. I think having a single issuance of regulations in the consumer area, just like in the safety and soundness area, has benefits. It has benefits in terms of speed and consistency.

The worry about such regulation's being arbitrary is a genuine worry. That is the reason for having a Board that is made up of a variety of different elements. The Board would include a former State regulator, a representative of the Treasury, a representative of the Fed, and three independent members, one of whom must be from the other party. So you have the kind of diversity needed for

any decisionmaking, but at the same time you have speed and consistency.

Senator BOND. Let me move to Chairman Greenspan.

Some of the discussion yesterday, Mr. Chairman, suggested that the Federal Reserve opposes a single regulator because it just doesn't want to give up its turf and that, in fact, the counterproposal discussed by the Fed is an opportunity to grab more turf. How do you respond to that?

Chairman GREENSPAN. The concept that we are putting forth has got nothing to do with the issue of turf. In fact, I think the history of the Federal Reserve, especially in recent years, is not of an institution seeking to increase its portfolio. Indeed, we had a little struggle on the issue of supervision and regulation of margins on stock index futures which we were not terribly happy getting involved with, but the Congress said, "it's yours." We're not looking to expand our activities.

The issue gets down to the question of how, in the consolidation, State nonmember banks are appropriately handled. As I said in my prepared remarks, the issue here is what is appropriate public policy, and there are a lot of people who argue, and, I think, with some persuasiveness, that the issue of having a single Federal regulator for all State-chartered institutions is an appropriate policy issue from the point of view of how you would structure the system if you were starting from scratch.

What I am not saying, because I don't believe it is true, is that we need additional examination authorities to do our job as the central bank. This has got nothing to do with that, and that's really the reason we put it up in the form in which we did. It's going to have to be a judgment, assuming that we move in this direction, of the Congress to decide where those institutions will ultimately reside.

I think it's a major question of the dual banking system, how it is constructed, in what form do we ensure its perpetuation, and it has got, in a sense, nothing to do with the Fed.

If you ask me if I look forward to expanding authorities at the central bank, the answer is, frankly, I do so with great reluctance, and would do so only if, in the judgment of the Congress, that it was the appropriate policy. We're not seeking additional authorities, at least those of us who focused on the implications of what happens when you take on a large load, I think, would not look upon it with great anticipation.

Senator BOND. Mr. Chairman, yesterday I was somewhat encouraged, because of my support for the dual banking system, by the information that we gathered that the new Treasury proposal would accept State exams for well-capitalized State-chartered institutions with less than $250 million in aggregate assets, and a proposal not to charge assessments on the first $1 billion in aggregated assets of State-chartered institutions. Do these changes meet some of your concerns with preserving the dual banking system? If so, do they go far enough? If not, why would these not take care of it?

Chairman GREENSPAN. Senator, as I understand it, rule making—which is very crucial to the whole issue—nonetheless remains

with the Federal Banking Commission, which is the charterer of national banks.

Let me take a minute just to indicate in some more detail what it is that bothers me about this particular process.

I think that a single regulator would, by its nature, move toward a narrow view of safety and soundness eventually, and I would say of necessity, because of what economists call regulatory bias. If you have a State-chartered organization which has certain powers granted by the State, but you have another organization which can construct a set of rules which you are required to maintain, if those rules are more stringent than the powers implicit from the States, they prevail.

It is the tightest set of rules which prevail, not an averaging or not just a choice. For example, just to take an extreme case, supposing there was a Federal Banking Commission rule which said that all small State-chartered institutions would have to have no more than a 20 percent loan/deposit ratio, the powers that might exist within the State to achieve much more expanded bank activities would be countermanded.

What I am saying is that so long as you have rulemaking at the Federal level, that the structure of the State's capability of maintaining the dual banking system, I would say, is materially inhibited.

While it is certainly the case that examinations would not be a problem, I think that, so long as the rules stay there, you have that particular problem.

The CHAIRMAN. If you are going to move on, I would like to make a point on that.

Senator BOND. OK. I am going to finish up and submit the remainder of my questions.

I want to go through one very brief set of questions, if you please.

The CHAIRMAN. If you would just yield for a moment here.

On that very point, Chairman Greenspan, let me tell you a concern that I have—and I would hope you would have, as well.

When we went through the savings and loan situation, and Mr. Fiechter and others have brought this up, over 70 percent of the losses occurred in just two States in State-chartered institutions.

If you subtract that part of the problem—which is what really blew the big hole through the side of the ship in terms of losses; now there are a lot of other things like interest rate mismatches and things over the years—you have an entirely different scale of problem.

I think it is a classic illustration of what happens when you put Federal deposit insurance underneath activities that State bank regulators may want to permit but that they do not want to insure. They want to stick the insurance responsibility with the Federal regulators.

How you line those up is not a simple matter, because you want to have room for innovation; you want NOW accounts; you want various other things that we have seen; but it has cost us tens of billions of dollars in that particular instance where we were backing individual States with Federal deposit insurance and the States decided that they wanted a charter that involved direct investment

in real estate and various other things that ended up being a killing combination. In fact, it capsized the whole system.

I do not think we should ride lightly over that point, especially when you have got Federal deposit insurance on the line and the Federal taxpayer on the line. I think you need to have a well-engineered, vigilant system. We have not had that in the past.

We ended up with the Bank Insurance Fund empty not all that long ago. Thank goodness, we have come back from that for a lot of reasons.

I think that recent history illustrates what can happen if we are not careful in terms of what Federal deposit insurance underwrites. Take that away and you have got quite a different discussion, but no one is proposing taking that away.

Chairman GREENSPAN. First of all, let us remember that this is an issue which we have discussed at length, and, indeed, there is an article in FIDICIA which delimits State powers in a manner which addresses the concerns that you are raising.

It requires, in effect, an awareness, implicitly, that there is Federal insurance for State institutions. I think that the dual banking system question is one which we endeavor to try to maintain what I would call this competitive tension issue, where we do not want to create a set of powers which, basically, is, in effect, individual States dipping into the Federal Deposit Insurance Corporation. That clearly would be inappropriate.

The CHAIRMAN. Well, that is what happened.

Chairman GREENSPAN. Sure. I do not deny that. That was the reason why the particular FIDICIA article was put in.

But let me just say, in general, that to take the savings and loan debacle—and that is exactly what it was—as representative of the types of things that we are dealing with in the Federal banking system, I think, is a stretch.

The problem with the savings and loans was not with the "regulation," per se. It started, basically, with constructing a depository institution which, by its nature, held long-term assets financed by short-term liabilities.

What we knew then and what we know even better now is that is a specialized institution which can exist only in a non-inflationary environment; and, that when inflation took hold and both short- and long-term interest rates rose very dramatically in the latter part of the 1970's, the cost of funds went up very quickly to adjust to the short-term interest rate increases, but the rates of return on the mortgage portfolios, because they were averages over a long period of time, only very gradually rose. And, as you well remember, we were confronted with a situation in which the industry was essentially insolvent.

The CHAIRMAN. Yes, but——

Chairman GREENSPAN. And that is what led to a lot of the regulatory excess that occurred.

The CHAIRMAN. Mr. Chairman, that is part of the problem. You are quite right to note it, and it has all been laid out. But you know as well as anybody sitting in this room that if you subtract out 70 percent of the losses that came from State-chartered institutions in two States, you have a remarkably different issue—notwithstanding what you have said.

Chairman GREENSPAN. I do not disagree with this.

The CHAIRMAN. Then the question is, how do we monitor what States do with the backing of Federal deposit insurance? In fact, if you go back and look at what happened in those instances, it was precisely because States decided that they wanted to have a very expansive charter.

The fact that it only happened in two States and not in 50, I think, makes that point. And the fact that 70 percent of the losses were concentrated in State-chartered institutions says something about it.

And if we do not come away with a lesson about the care with which we apply the Federal taxpayers guarantee with Federal deposit insurance both in terms of what the scope of business is and how it is to be regulated and monitored, then we have not really learned anything.

Chairman GREENSPAN. I was merely responding to Senator Bond's question about what actually is occurring with respect to the question of the dual banking system, and whether an exemption of examination for the smaller institutions is adequate to assuage my concerns about the system. And my answer in response to him was: No, it does not.

I am not disagreeing with your concerns, which I think are quite valid and which we share. Namely, that we have to be aware in the whole process of how the dual banking system is functioning to make certain that there are not inappropriate activities, actions, and the like coming from the Federal system to the State system, or vice versa.

The CHAIRMAN. Thank you, Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

I want to finish this up very quickly. I turn now to Comptroller Ludwig.

Yesterday, Secretary Bentsen told us that there was a task force dealing with the consolidation proposal. I assume you were a member of that task force. In the course of your agency's work, did you or any member of your staff discuss the consolidation issue or proposal with a member of the White House staff?

Mr. LUDWIG. Yes, sir. NEC, if you count that as White House staff—that is, the National Economic Council—and the OMB.

Senator BOND. Who are the individuals you discussed it with?

Mr. LUDWIG. I would be pleased to provide the names to you. Ellen Seidman, who is on the NEC, was part of those discussions. And Chris Edley, who is on the staff of the OMB, was part of those discussions.

Senator BOND. Did you have any discussions with others not on the NEC?

Mr. LUDWIG. The interagency task force also included Justice.

Senator BOND. Did you have any discussions with Mr. Hubbell? Who was representing Justice?

Mr. LUDWIG. No, sir, to my knowledge, he was not involved. Who was representing Justice?

[Pause.]

Senator BOND. Well, I will let you provide——

Mr. LUDWIG. Oh, yes, Walter Dellinger.

Senator BOND. Who?

Mr. LUDWIG. Walter Dellinger was representing Justice.

Senator BOND. Did you discuss it with Mac McClarty, or William Kennedy?

Mr. LUDWIG. No.

Senator BOND. In any of those discussions was the question of Worthen Banking Corporation, Worthen Bank of Little Rock, Worthen Financial, Madison Guaranty, or Whitewater brought up?

Mr. LUDWIG. No, sir. Absolutely not.

Senator BOND. All right. Thank you.

We would appreciate it if you could supply us with who you discussed it with at the White House.

Mr. Hove and Mr. Fiechter, same question. Did you serve on the task force?

Mr. HOVE. No, sir, I did not.

Senator BOND. Mr. Fiechter?

Mr. FIECHTER. I went to two meetings of what, I guess, might have been a task force.

Senator BOND. Same question. Did you have any discussions with the White House?

Mr. FIECHTER. No.

Senator BOND. Mr. Chairman, thank you very much. So we will not starve to death, I will offer to submit my few remaining questions for the record.

The CHAIRMAN. Thank you.

Let me just cover a couple of other things here on the theory that no one will starve to death, at least in the next few minutes.

Senator BOND. I will not contribute to the starvation, then.

The CHAIRMAN. Mr. Ludwig, Chairman Greenspan in his statement lays out an option approach. I am going to just read it quickly, aloud, and ask you to react to it. What is wrong with this? Or where are the problems that you see with it, to the extent that you do?

He says that under this approach he is proposing, and I quote:

> Reduction of the number of agencies with supervisory and regulatory power from four to two: a Federal Banking Commission and the Federal Reserve;
>
> Elimination of duplicative examinations;
>
> Establishment of one Federal supervisor for all depository institutions in any single banking organization, regardless of the charter class of the individual entities.
>
> Under this approach, the OCC and OTS would be merged and renamed the Federal Banking Commission. The FDIC would no longer examine healthy institutions, but would join in the examination of problem entities.
>
> The Fed would, as now, promulgate rules for the establishment of U.S. offices of foreign banks and foreign offices of U.S. banks.
>
> The Federal Banking Commission would determine permissible activities for national banks and Federal savings associations.
>
> The Federal Banking Commission would also be the supervisor of all independent national banks and thrifts, and all depository institutions, and any banking organization whose lead depository institution is a national bank or a thrift.
>
> The Fed would be the supervisor for all independent State banks and all depository institutions in any banking organization whose lead depository institution is a State-chartered bank.
>
> The Supervisor of Depository Institutions would examine, take enforcement actions, establish operational rules, and act on applications for all the depository institutions under its jurisdiction regardless of the bank's charter class.

I will just stop there.

What do you think about that structural arrangement?

Mr. LUDWIG. I must say the proposal put forth today by Chairman Greenspan is certainly a thoughtful proposal. But, the areas off the top of my head that trouble me—let me put them in order.

First, there is a genuine tension between charter-shopping, on the one hand, and the kinds of dynamism in the financial services system, on the other, that Chairman Greenspan is concerned about. One thing that I would worry about is competition in laxity, a term coined by former Fed Chairman Burns, as a matter of fact. It is not something that cannot be dealt with, but it is a serious flaw.

Number two, the issue of the holding company regulator is a big issue because of the reasons I mentioned in my testimony and in answering questions. These are functionally organized institutions, and the functions go right through the holding company and some of their subsidiaries into the bank. It is very seamless. You simply have to be able to examine and regulate the whole organization. I think that is very important for safety and soundness.

I think there is a genuine issue here regarding the consumer confusion that I mentioned to Senator Bond. We are primarily here for the public good, and that would worry me some.

The best of all possible worlds is clearly a single regulator with the kinds of flexibility that the Administration has built in its proposal. At the same time, Chairman Greenspan's comments are valuable and interesting. As I say, in terms of areas that concern me most, one would be the issue of consumer confusion. A second would be an unlimited choice of regulator that can devolve into forum-shopping, which I think is not healthy. And, a third would be absence of an examination mechanism that is able to go from the holding company all the way down to the bank, because you never know where the actual functional lines are going to be evolving in a banking organization and you have to look at the entire entity for safety and soundness purposes.

The CHAIRMAN. With respect to the consumer protections and consumer issues, I was pleased, Chairman Greenspan, to hear you refer to the Boston Fed study as a smoking gun today, because it is that. We have seen it as that.

But, I have got to tell you, from my vantage point as I watch the regulators—it has just been my observation that the Fed is usually the slowest to act, by and large, on consumer issues, it seems to be the least responsive.

And I think something needs to be done about it. I do not know how that is to be accomplished, but I believe there is a greater sensitivity, awareness, and higher level of commitment to the issue in the other bank regulatory agencies.

If we are going to have consolidation and the Fed is going to have a broader role, as you propose, then I think figuring out how the laws are applied fairly with respect to community investment, lending problems, redlining, etc., should be taken on aggressively by the Fed.

I do not mean aggressive just for the sake of being aggressive, but because we have a big problem out there. There is no reason for it to have gone on all this long.

Chairman GREENSPAN. Mr. Chairman, what we see, with respect to the question of community reinvestment, is that banks have not

expanded in areas where I think they should be expanding because I think there are profitable opportunities there.

We think that the purpose of CRA, which we support fully, is to get banks to recognize that they are foregoing avenues of investment which would be helpful to their institutions.

The one issue that we are concerned about—and I just say a number of consumer advocates are concerned, too, because we have talked to them, is that what we do not want are a number of fly-by-night banking institutions because there is political pressure being imposed to go into a number of areas where they choose not to try to make a profit but to effectively get "CRA credit," if I may say in quotes, by just making a major program and essentially driving out other individuals.

I had a very poignant discussion a while back with a banker who had been successful in maintaining a fairly expansive and profitable operation in an urban area because he went into the particular areas—low-income, middle-income groups—and was able to get viable business.

As soon as it became an issue that CRA credit was an important issue, he found that a lot of competitors came in, squeezed the margins—because they did not care about the margins—to a point where he was driven out of business.

The issue that we have to be very careful about here is to make certain that what we do is get people into those areas who are in it for the long run and not because there is immediate political pressure, because at some point that political pressure is going to come off. And what we want to be certain of is that those banks do not just pick up and leave.

If we are slow—and I will not deny that that may not be an inappropriate perception—it is basically because we want to make certain that when the rules are written, they are written in a manner which attracts people to stay in areas and to function in those long-term contexts which, as I understand it, is the purpose and the statute of the Consumer Reinvestment Act.

The CHAIRMAN. Well, take into that the lending discrimination problem, if an African-American citizen who is creditworthy but is turned down because a banker perceives that there is not an economic opportunity there to make a fair return when, in fact, there is, that not only is a bad economic decision it is against the law. That is absolutely, fundamentally wrong. Why do we still seem to be so slow in that area? Time is awasting. I want an answer that is going to last, but people who need loans and are creditworthy deserve to get them.

Chairman GREENSPAN. On the issue——

The CHAIRMAN. If they get it 2 or 3 years from now, it may not do much good for them.

Chairman GREENSPAN. I am not talking about waiting for 2 or 3 years.

The CHAIRMAN. I understand. I just want to make it clear.

Chairman GREENSPAN. The issue of discrimination and CRA are actually two different questions. Discrimination is illegal. That is a question of fact. The issue is: If one violates the law, the law should and is imposed. CRA is a much broader question of endeavoring to get lending out there.

The CHAIRMAN. I understand that.

Chairman GREENSPAN. One of the issues that I think the Boston study assisted us on is to get a real interesting insight into what does not appear to be discrimination, in fact, actually is.

Until we realize—because let me tell you, we have had a problem which, early on, before the Boston study, from whatever we could gather, the people who had fairly good credit records and had fairly good credit applications got mortgage loans irrespective of race or any other elements in their particular application.

What we found out in the Boston study was that the discrimination was occurring amongst those applications which were less than complete or less than creditworthy.

The applications that were deficient submitted by whites were far more often repaired by consultation, and by assistance by the bank lending officers than for African-Americans or Hispanics.

Where the crucial issue clearly lies is in the repair of inadequate applications. That insight, I think, now applied far more generally has given us a major capability of enforcing both the statutes against discrimination and CRA.

I think that major advances have been made in this direction. I must say that it is an issue which we very strongly support and are very much of the opinion that, rather than do something quickly, we want to make certain that it is done right and that it will work.

When we have concerns about some of the applications, applying CRA to specific rules, our view, in fact, is coming in from an economic perspective to make certain that it functions and not that it fails.

I will say this. If we have a set of rules which does not work, nobody's interests are served.

The CHAIRMAN. Let me conclude. We have had a pretty good discussion. There is more we could cover, but the hour is late.

What I would like to do is repeat what I said earlier. That is, that I would like you, Chairman Greenspan, to lead what I hope will be the final stage of discussions for the Fed and not delegate it to somebody else, and work with the Treasury Secretary to see if we cannot resolve the remaining 20 percent disagreement.

Let us see if we cannot find a way, in a short period of time, to resolve these issues. I think it is important that we do it. We have got an opportunity here.

I do not want this window to close on us. Because if it does, I am not sure when it will come around again. I do not think that serves the public interest. I think the public interest is best served if we can find a common point of view.

If we cannot, then we will go ahead and we will fight it out the other way. But one way or another, we have got to get it resolved. I would like to take the opportunity in the next week to 10 days to see if we cannot get this done and move ahead with a degree of solidarity. Can I count on you to lead that effort from the Fed side, Mr. Chairman?

Chairman GREENSPAN. Certainly, Mr. Chairman.

The CHAIRMAN. And Mr. Ludwig, I want you to convey that, if you will, to the Treasury Secretary, and I will do so myself directly.

Let me thank you all. We may have some questions to give you for the record. I appreciate your being here today. I think we have made some good progress.

The Committee stands in recess.

[Whereupon, at 1:19 p.m., the Committee was recessed, to reconvene at the call of the Chair.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR CHRISTOPHER S. BOND

Mr. Chairman, thank you for providing us with the opportunity to hear from all interested parties on the issue of regulatory consolidation.

As I mentioned yesterday, I am not a strong supporter of the single regulator proposal. However, neither have I committed myself to supporting any other specific consolidation proposal.

Yesterday, I felt that Secretary Bentsen made some very compelling arguments in favor of the Administration's proposal, and I would like to question this panel, especially Chairman Greenspan, to get their reaction to those arguments.

I also commend Secretary Bentsen for altering the Administration's original proposal to address some of the industry's and the Fed's concerns. Whether those concerns truly have been addressed in full has yet to be determined, but I commend him for his efforts.

We all agree that consolidation is needed and I hope that all of the interested parties will be able to reach some sort of compromise so that we will be able to move forward with legislation to consolidate the Federal banking agencies.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR BARBARA BOXER

I support reform of the current Federal banking regulatory system. A diagram of our current system would probably have enough criss-crossing lines and overlapping boxes to make health care reform look easy. We have to fix our current system because the inefficiency causes a regulatory burden which hinders the industry and hurts consumers.

I am confident that the Administration's efforts to reform the regulatory system and streamline the process will lessen the regulatory burden on our institutions while maintaining the integrity of our dual banking system, and facilitating the full enforcement of laws designed to promote fair lending in our communities.

I appreciate the presence of our distinguished panel of witnesses who represent the Federal regulatory agencies and look forward to their testimony.

I have tremendous respect for Chairman Greenspan and am confident in his leadership. The Fed deserves much credit for the way it has conducted monetary policy and the way it has responded to potential financial crises. Clearly, we must not enact legislation which would impede the Fed's future ability to act effectively in either of these respects.

I must say, however, I have concerns regarding the Federal Reserve's record on enforcement of the Community Reinvestment Act, a law that I wholeheartedly support. I intend to raise some questions for Chairman Greenspan regarding CRA enforcement and I look forward to his responses.

Thank you.

PREPARED TESTIMONY OF ALAN GREENSPAN

CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE BOARD, WASHINGTON, DC

Mr. Chairman, I am pleased to appear today before the Senate Banking Committee to give the views of the Federal Reserve Board on proposals to consolidate the banking regulators into a single agency. We have prepared a detailed analysis of such proposals, which I have attached to my statement. My remarks this morning will highlight that analysis.

The proposals to create one Federal bank regulator have the clearly stated objectives of reducing the Government's costs of regulating and supervising banks, of reducing bankers' costs and burdens from duplicative examination and overlapping supervision, and, in general, making the supervisory process more efficient and more accountable. The Federal Reserve Board shares these goals, but disagrees with the approach of one regulator for achieving these objectives. However, the Board believes that it is possible to achieve virtually all of these proposals' objectives without creating the risks of one regulator that so trouble us.

In reaching this conclusion, the Board tested various proposals against the fundamental principle that the purpose of regulation is to enhance the capability of the regulated entity to contribute effectively to the Nation's long-term economic growth and stability. We have concluded that for this to be accomplished four subsidiary principles must be achieved:

- First, there should not be a single monolithic Federal regulator.
- Second, every bank should have a choice of Federal regulator.
- Third, there should be only one Federal regulator for all of the depository institutions in any single banking organization.
- Fourth, the U.S. central bank should continue to have its essential hands-on involvement in supervision and regulation.

A consolidated single regulator would deprive our regulatory structure of what the Board considers to be the current invaluable restraint on any one regulator conducting inflexible, excessively rigid policies. Laws on bank regulation and supervision should be drawn very generally leaving the specifics to agency rulemaking. This vests the agencies with a broad mandate and a not inconsiderable amount of discretionary power. Hence, a safety valve is vitally needed to avoid the exercise of arbitrary actions. A denial of, or severe limitation of, charter choice closes off a safety valve inevitably leading to greater micromanagement of banks and a lessened market for bank credit. We must avoid a regulatory structure that inhibits economic growth.

The present structure provides banks with a method—albeit one neither easily accomplished nor often taken—of shifting their regulator, an effective test that provides a limit on the arbitrary position or excessively rigid posture of any one regulator. The pressure of a potential loss of institutions has inhibited excessive regulation and acted as a countervailing force to the bias of a regulatory agency to over-regulate.

The dual banking system and multiple Federal regulators have facilitated diversity, inventiveness, and flexibility in our banking system, so important to a market economy subject to rapid change. A single Federal regulator would effectively end the dual banking system: It would become an empty shell if a State-chartered entity had no choice of Federal regulator or—reflecting a recent FDICIA provision—different asset powers. The dual banking system cannot survive consolidation at the Federal level. I, as well as my colleagues on the Board, believe that would be a tragic loss.

In addition to the effective loss of the dual banking system, the single regulator contemplated in current proposals would be disconnected from broad economic policy issues. This is a problem because a regulator that does not have macroeconomic responsibility for its actions is likely to inhibit prudent risk-taking by banks, thus limiting economic growth and stability. The central historic purpose of banking is to take risks through the extension of loans to businesses and others. Economic growth in our system could not occur without risk-taking by entrepreneurs and small and large businesses. Risk-taking requires financing. Thus, either an unwillingness or an inability of lenders to take risks would slow the expansion of our Nation's employment and income. This fact creates a significant policy tradeoff in banking regulation, especially because of the Government guarantee of bank deposits. On the one hand, regulators are concerned about bank failures and their effects on the economy, as well as their cost to the insurance fund. On the other hand, banks need to take risks to finance growth. Tradeoffs are required, and a swing in either direction can create both short- and long-term problems.

Indeed, a single regulator with a narrow view of safety and soundness and with no responsibility for the macroeconomic implications of its decisions would inevitably have a long-term bias against risk-taking and innovation. It receives no plaudits for contributing to economic growth through facilitating prudent risk-taking, but it is severely criticized for too many bank failures. The incentives are clear.

The Federal Reserve's stabilization objectives cause us to seek to avoid either excessive tightness or ease in our supervisory posture. The former leads inevitably to credit crunches, and the latter to credit policies that contribute, with a lag, to bank losses and failures. This is not to say, as some have advocated, that the Fed itself should be the only regulator. A single regulator Fed would be prone to arbitrary and capricious behavior as would any other single bank regulator. We would thus oppose such an initiative, since, as a single regulator, we would inevitably drift to increasing day-by-day control of banking institutions who would soon become less innovative and competitive—a severe loss to the Nation.

Not only is it important that one of our regulators have macroeconomic responsibility in order to carry out the regulatory function properly, but also our central bank must continue to have hands-on involvement in supervision and regulation in order, effectively, to carry out its macroeconomic responsibilities. Joint responsibilities make for better supervisory and monetary policy than would result from either a supervisor divorced from economic responsibilities or a macroeconomic policymaker with no involvement in the review of individual bank's operations. Without the hands-on experience of regulation and supervision, and the exposure to the operations of banks and markets provided by such experience, the Federal Reserve's es-

sential knowledge base would atrophy. Its deliberations would become increasingly academic and the Nation's central bank would soon resemble an ivory tower rather than an institution necessarily involved with the day-to-day activities of our economic and financial system. It is our knowledgeable examiners and supervisors—knowledgeable about banks, financial markets, and the payment systems that connect them—that provide the expertise the Fed needs. And the fact is that we simply could not retain such staff if they were not actively involved in the process; reading reports or joining as junior participants in a handful of examinations would not be sufficient.

Some have argued that most foreign central banks are not involved in bank supervision and regulation. In fact, as described in more detail in the attachment, central banks in all but one G–7 country (Canada), in most cases *de jure* but always *de facto*, are closely involved with the supervision of banks in their countries and internationally. More broadly, the central bank has either total or shared responsibility for bank supervision in three quarters of the nations in the OECD. One example that is frequently used by those that believe that central banks in foreign countries are not involved in supervision is the Bundesbank. The facts are quite the contrary: The Bundesbank has more supervisory staff than the German Federal Banking Supervisory Office, reviews the auditors' reports before the Banking Supervisory Office receives them, and has veto power over certain liquidity and capital regulations of that office. In all industrial countries, either central banks or Finance Ministries, or both, are involved with supervision because nations have come to understand that bank supervision has economic consequences that are important for stability and economic growth.

Removing the Federal Reserve from supervision and regulation would greatly reduce our ability to forestall financial crises and to manage a crisis once it occurs. In a crisis, the Fed could always flood the market with liquidity through open market operations and discount window loans. But, while rapid liquidity creation is often a necessary response to a crisis, supervision and regulation responsibilities give the Fed insight and the authority to use less blunt and more precisely calibrated techniques to manage such crises and, more importantly, to avoid them. The use of such techniques requires both the clout that comes with supervision and regulation and the understanding of the linkages between supervision and regulation and macroeconomic growth and stability.

The Fed is required to play the key role when systemic breakdown threatens. The attachment to my statement provides some detail about Federal Reserve involvement in financial crises over the last decade. As you review it, I request that you consider certain key questions.

Could the Fed, without supervisory responsibilities, have successfully managed the Mexican debt crisis of 1982, the 1985 collapse of Ohio and Maryland privately insured thrifts, the stock market crash of 1987, or the Drexel failure of 1990?

Would the banking community have been persuaded to respond, as they did in each of these cases, by a central bank with much more limited authorities to affect events? Would the Fed have been able to play a role in persuading many of the banks to complete the payments necessary to prevent payments gridlock without supervisory knowledge and authority?

Finally, would a single bank regulator with no macroeconomic stabilization responsibilities have given the proper weights to financial market stability and economic growth? Without market expertise, would such a regulator have recognized early enough many of the problems central to resolution of these crises?

In my judgment, the risk that the answer to all of these questions is "no" is too great to take.

There are ways, short of the creation of a single agency, to address the problems in the current regulatory structure and reduce the costs of regulations. The crux of the issue is duplicative examination of banks. This problem could be eliminated by a regulatory system that maintained two Federal regulators, but provided that, in general, only *one* of those regulators supervised all the depository institutions in any banking organization.

While there are many ways to achieve an improved regulatory structure, one such approach supported by the Federal Reserve Board that could be implemented with a relatively modest series of reforms would contain the following provisions:

- Merge the OCC and the OTS. This organization would become the Federal Banking Commission.
- Remove the FDIC from examining healthy institutions.
- Put all independent national banks, all lead national banks that are part of a holding company, and all thrifts under the purview of the Federal Banking Commission; and put all independent State banks, and all lead State banks in a holding company under the purview of the Federal Reserve.

- Provide that the supervisor of the lead depository in a banking organization also be the supervisor and regulator of all the depository institutions in the organization regardless of the charter class of those affiliates.
- Finally, treat all U.S. activities of foreign banks as now, with adjustments where necessary to reflect the changes in the regulatory structure described above.

The Board has not yet adopted a position on the supervision and regulation of bank holding companies and their nonbank affiliates. There are two broad options, and a strong case can be made for each:

- Under the first option, all holding companies and their nonbank affiliates could remain under the Fed's jurisdiction, continuing to provide uniform rulemaking for competitive equity and a substantial role for the Fed in shaping the financial structure, so useful for stabilization and systemic risk purposes.
- Under the second option, the jurisdiction of virtually all holding companies could be split between the Fed and the FBC on the basis of the charter class of the lead bank. However, for systemic risk reasons, jurisdiction over the holding companies and nonbank affiliates of a modest number of banking organizations that meet certain criteria—such as large size and payment and foreign activity—would be retained by the Fed, even if the lead bank of the organization had a national charter organization.

Under either option, the number of banking organizations subject to multiple regulators would drop sharply.

Whichever holding company option is selected, the general proposal would have the Fed supervise and regulate State nonmembers, with these banks being a significant addition to our existing regulatory load. This expansion of the Fed's supervisory functions rests solely on the notion that in a two-agency structure, it is desirable to have supervision and regulation responsibility defined clearly by charter class in order to preserve the dual banking system. The Board makes no case that responsibility for such banks—that account for almost one-quarter of bank assets—is needed for financial stability and monetary policy purposes. However, responsibility over banks of various sizes and locations, as under our existing authorities, is required if the Fed is to perform its functions effectively.

The Board's approach would achieve essentially all of the benefits of one consolidated regulator while incurring virtually none of its risks. It eliminates duplicate supervision of depositories in a single banking organization and greatly reduces overlapping regulation. It maintains the dual banking system and permits any bank to change Federal regulator by changing charter, thus ensuring a set of checks and balances on the arbitrariness of a single regulator. It maintains the healthy process of dynamic tension in bank rulemaking. It maintains the practical knowledge and skill, and the influence and authority, of the central bank, so critical for crisis prevention, crisis management, and monetary policy. It maintains the valuable perspective the central bank brings to supervision. In short, the proposal would avoid an inflexible, single regulator, preserve the dual banking system, assure that an economic perspective is brought to supervision and regulation, and maintain a strong central bank.

The Views of the Board of Governors of the Federal Reserve System on the Consolidation of Bank Supervision and Regulation

Introduction and Summary

The Board of Governors of the Federal Reserve System agrees that the Congress should take steps to reduce duplicative bank examinations and overlapping regulation. But, it is concerned that the single regulator proposals do so by removing the benefits of the existing system and creating new problems and risks, without addressing the need for fundamental modernization of permissible banking activities. Moreover, the Board notes that most of the excess burden banks now face reflects legislative and regulatory reaction to stresses in the banking system that became evident after the mid-1980's. Most of these burdens would remain, or, at best, be only marginally reduced by reforms of the regulatory structure that would leave untouched the supervisory micromanagement required by recent legislation.

Nonetheless, the Congress could reduce regulatory burden and improve Government efficiency by addressing regulatory overlap and duplicative examinations. In doing so, the Board urges the Congress to balance the benefits of regulatory reform with the need to preserve both the special and unique nature of the U.S. banking system and the ability of the central bank to perform effectively its stabilization functions.

The single regulator proposals seek to resolve the problems in the regulatory structure by creating a single Federal bank and thrift regulator that would take

over the current regulatory roles of the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS), and most of those of the Federal Reserve (FR). While such an approach would deal with duplication, inconsistency, and overlap, it would create problems and run risks that are far more serious. In short, the Board believes these proposals are poor public policy because they are adverse to three principles which the Board believes are basic to any bank regulatory structure:

1. To avoid the risks associated with the undue concentration of regulatory power, there should be at least two Federal regulators, one of which should have macroeconomic responsibilities. Any single regulator would be prone to arbitrary actions because it would not have the checks and balances provided by two or more agencies. A single regulator would thus be more likely to make sudden and, perhaps, dramatic changes in policy that would add uncertainties and instability to the banking system. A single regulator without macroeconomic responsibilities would also have a tendency to inhibit prudent risk-taking by banks, thus limiting economic growth.

2. The dual banking system—in which banks can be chartered by either the States or the Federal Government—should be preserved. It has served this Nation well. Without a choice of Federal regulator, such a system cannot survive. Choice of both charter and Federal regulator facilitates the diversity of approach that has made the U.S. banking system the most innovative in the world.

3. As the Nation's central bank, the Federal Reserve System should continue to have direct hands-on involvement in supervision and regulation of a broad cross-section of banking organizations in order to carry out its core central bank responsibilities to insure the stability of the financial system, manage the payment system, act as a lender of last resort, and formulate and implement a sound monetary policy. Without such involvement, the central bank would not be able to maintain either its knowledge of markets and banking or the influence of a regulator so necessary for both macroeconomic policy development and crisis management. It would pose unnecessary risks to remove the Federal Reserve from supervision and regulation at a time when the continuing evolution of new financial instruments, increasing globalization of financial markets, the implementation of more active financial management strategies, and the speed of electronic technology may make systemic risk containment more difficult.

The Board believes that it is possible to achieve virtually all of the public policy benefits of the single regulator proposals without violating any of these principles.

The critical impairment of the Federal Reserve's hands-on authority over, and involvement in, the activities and operations of banks, as called for by all of the current proposals, would significantly undermine the effectiveness of the Federal Reserve in carrying out its public policy responsibilities. The Federal Reserve must know, in a practical detailed way, how the banking system works, where the vulnerabilities lie, and have the ability and authority to influence banking organizations' actions. Reports from another agency—or Fed representation on another agency's board—would not provide such experience. Access to written supervisory reports at another agency might be useful for assessing a specific problem in a specific bank. It would add little to the Fed's capabilities in addressing financial crises. As Gerald Corrigan, the former President of the Federal Reserve Bank of New York, recently noted, the hands-on intimate knowledge from supervisory responsibilities ". . . cannot be taken out of the closet only when needed and it certainly cannot be realized by reading another agency's exam report."

A single regulator without the responsibility for the economic consequences of its actions would inevitably result in a regulatory stance with a long-term bias against risk-taking—and, hence, economic growth—and with likely shorter-run policy shifts between excess laxity and restraint. Any single regulator, even if it were the Federal Reserve, would also have a bias toward arbitrary actions and would eliminate the beneficial diversity and pluralism of our dual banking system. There is little reason to believe that such a regulator would be any more efficient in an economic or managerial sense, and it would certainly be less flexible than our current structure with its checks and balances. Indeed, most of the prospective regulatory cost savings that are likely to result initially from the creation of a single bank regulator would also accrue to a regulatory system which included the Federal Reserve. Moreover, such cost savings, if there were only one regulator, would likely be dissipated over time as the bureaucratic inefficiencies of a monopoly regulator took hold. In addition, a single regulator is likely to impose costs on the economy from slower economic growth, more variable supervisory policy, and reduced effectiveness of the macroeconomic stabilization policies of the Federal Reserve, all of which could easily

swamp any dollar cost savings to the Government from combining the regulatory agencies into a single agency.

Essentially all of the benefits of a single regulator can be obtained with less disruption and risk while still retaining the formidable benefits of the present system. Elimination of duplicate examinations and adoption of a single supervisor for virtually all banking and thrift organizations can be accomplished with two banking agencies, each of which would be given clearly defined supervisory responsibilities. Such an approach would preserve the dual banking system by permitting real choice of Federal regulators, and maintain the ability of our central bank to fulfill its responsibilities.

Central Banking and Supervision and Regulation

Since its inception the Federal Reserve has been at the nexus of monetary policy, the payment system, and bank supervision and regulation. Indeed, the importance of supervision, as a fundamental responsibility of the central bank, was emphasized in the 1913 preamble of the Federal Reserve Act, which called on the Federal Reserve ". . . to establish a more effective supervision of banking in the United States." Over the years, it has become clear that the Fed is a better supervisor because it has economic stabilization responsibilities. Such responsibilities require it to evaluate the economic implications of its and other agencies' supervisory stance, in effect recognizing that safety and soundness goals include concerns about the stability and growth of the economy. These joint responsibilities, the Board believes, make for better supervisory and monetary policy than would result from either a supervisor divorced from economic responsibilities or a macroeconomic policymaker with no practical experience in the review of individual bank's operations.

To carry out its responsibilities, the Fed has been required over the decades to build up extensive, detailed knowledge of the intricacies of the U.S., and indeed the world, financial system. That expertise is the result of dealing constantly, and in detail, with changing financial markets and institutions and their relationships with each other and with the economy, and from exercising supervisory responsibilities. It comes as well from ongoing interactions with central banks and financial institutions abroad.

Federal Reserve supervisory and regulatory activities have been an integral and indispensable aspect of this process. Continuing interactions with banking organizations, both large and small, is one of the key ways that the Fed has acquired detailed insights into how our system functions. This view is not simply one held by the current Board. At least since the Roosevelt Administration, Federal Reserve Boards and their chairmen have felt the necessity for the central bank to be involved actively in the formulation and execution of supervisory policy, and have made that point to the large number of private and public groups and commissions that have reviewed the issue.

To meet the public policy objectives given to it, the Federal Reserve must maintain a staff of skilled supervisors. It would not be able to attract and maintain such a staff with the limited functions outlined in the single regulator proposals. Even with a knowledgeable staff, it would be virtually impossible to get an operationally effective sense for developments by reading reports or having discussions with the staff of a new single regulator. The Fed would not be in a position to evaluate requests for discount window loans to problem banks and thrifts because it would not have either timely knowledge of the financial condition of these banks or highly competent supervisors to evaluate the position of another agency's examiners. The authority to examine for discount window purposes would be meaningless because it would come into play much too late if it were exercised only at the time of the loan request. To be meaningful, such authority would require full periodic examination and review of a significant number of banks so that the Fed would be able to know the condition of the banking system, as well as the condition of the institution to which it is lending, and have the on-going supervisory expertise to evaluate the new agency's view of the potential borrowing entity. Indeed, Congress recognized in FDICIA the need for independent Federal Reserve evaluation of depositories to which the Fed extends credit. The sample of banks subject to Federal Reserve examination in the current proposals falls far short of our view of what is required.

Similarly, examination for payment system purposes (as is advocated in some reform proposals) cannot simply be a review of controls, procedures, and systems, as important as that is. What is most relevant is the risk exposure that domestic and foreign participants in the dollar clearing and payment systems create on Fedwire to the Fed (and hence to the public) or to banks on private systems. The day-to-day evaluation of these risk exposures requires prudential examination and supervision authority of a general nature or a cadre of skilled examiners that can evalu-

ate another agency's exam. Anything less may give the Fed apparent responsibility without the necessary expertise or authority.

Eliminating the U.S. central bank from adequate hands-on supervision and regulation would remove the accumulated human capital built up over 80 years of experience with a wide spectrum of banking organizations. Such capital cannot—without linkage to economic policymaking—be duplicated in the short-run or transplanted. Moreover, without the hands-on experience of regulation and supervision, the Federal Reserve's essential knowledge base would atrophy. Consequently, its deliberations would become increasingly academic and the Nation's central bank would soon resemble an ivory tower rather than an institution necessarily involved with the day-to-day activities of our economic and financial system. There is regrettably a view in some circles that monetary policy can be conducted by a central bank with no practical knowledge of banking or responsibility for bank operations. Indeed, some observers argue that monetary policy would be improved if the Federal Reserve's attention were not diverted to supervisory and regulatory issues. The Board, recognizing that banks and the financial system are the interface between monetary policy and the economy, disagrees strongly with this point of view. It believes that such an academic approach would be likely to lead to seriously deficient policymaking by reducing the Fed's practical understanding of markets, credit conditions, and institutions.

Removing the Federal Reserve from supervision and regulation would greatly reduce its ability to forestall financial crises and to manage a crisis once it occurs. In a crisis, the Fed, to be sure, could always flood the market with liquidity through open market operations and discount window loans; at times it has stood ready to do so, and it does not need supervision and regulation responsibilities to exercise that power. But, while often a necessary response to a crisis, such an approach may be costly, destabilizing, and distortive to economic incentives, as well as being insufficient. Supervision and regulation responsibilities give the Fed insight and the authority to use less blunt and more precisely calibrated techniques to manage such crises and, more importantly, to avoid them. The use of such techniques requires both the clout that comes with supervision and regulation *and* the understanding of the linkages among supervision and regulation, prudential standards, risk-taking, relationships among banks and other financial market participants, and macrostability.

CRISIS MANAGEMENT

Our financial system—market oriented and characterized by innovation and rapid change—imparts significant benefits to our economy. But one of the consequences of such a dynamic system is that it is subject to episodes of stress. Recent examples include a series of international debt crises, a major stock market crash, the collapse of the most important player in the junk bond market, the virtual collapse of the S&L industry, and extensive losses at many banking institutions. In such situations the Federal Reserve provides liquidity, if necessary, and monitors continuously the condition of depository institutions to contain the secondary consequences of the problem. The objectives of the central bank in crisis management are to contain financial losses and prevent a contagious loss of confidence so that difficulties at one institution do not spread more widely to others. The focus of its concern is *not* to avoid the failure of entities that have made poor decisions or have had bad luck, but rather to see that such failures—or threats of failures—do not have broad and serious impacts on financial markets and the national, and indeed the global, economy.

The types of financial crises that arise from time to time are rarely predictable and almost always different. The Fed's ability to respond expeditiously to any particular incident depends on the experience and expertise that it has accumulated over the years about the specifics of our system and its authority to act on that knowledge. In responding to a crisis or heading off potential crises, the Federal Reserve continuously relates its supervisor-based knowledge of how individual banks work with its understanding of the financial system and the economy as a whole.

This does not necessitate comprehensive information on each individual banking institution, but it does require that the Fed know, in depth, how institutions of various sizes and other characteristics are likely to behave and what resources are available to them in the event of severe financial stress. It currently gains this insight by having a broad sample of banks subject to its supervision and through its authority over bank holding companies.

The Federal Reserve employs its accumulated experience and expertise, in large measure, to work with other regulators here and abroad and with private parties to build strong institutional structures resilient to the inevitable strains that hit financial systems. For example, in consultation with the other agencies, the Fed uses

its comprehensive economic knowledge to ensure that the economic consequences of proposed rules are considered. In addition, the Fed's leadership with G–10 central banks has led to higher and more consistent capital standards and vastly improved criteria for payment system management.

The Fed plays the key role when systemic breakdown threatens. Such episodes invariably create fear and uncertainty in the financial markets. Fear of counterparty risk escalates, and the threat of paralysis in financial markets and the breakdown of payment and credit arrangements that underpin them become all too real. It is important that a regulatory authority fully familiar with the dynamic international economic and financial forces in play be available to counsel and urge rational responses—and, as a last resort, provide liquidity. If regulatory authority is vested in a single agency and little in the central bank, our Nation's ability to forestall or to respond efficiently and effectively to a crisis would surely be impaired.

Perhaps a few examples of Federal Reserve involvement in past crisis management would help illustrate and clarify these points.

In early 1990, the parent of the leading dealer in junk bonds, Drexel Burnham, failed, with potential significant impacts on financial markets. The Fed's concern was not for the failure of a particular securities firm, but rather the impact that failure might have on other financial institutions and on the functioning of capital markets essential to economic growth and job creation.

From the central bank's perspective, the greatest threat was potential gridlock in the system of paying for, and delivering, securities. Orderly liquidation of Drexel's substantial holdings, especially of mortgage-backed securities, was nearly stymied by the fears of market participants who became exceedingly reluctant to deliver securities or make payments to Drexel or finance its securities position. This caution, while entirely understandable, could have brought the liquidation process to a standstill. Had this occurred, capital markets would have been disrupted and the financial system would have become more vulnerable in the future to the slightest whiff of problems at any major market player.

The key to preventing gridlock was the cooperation of clearing banks, through whose books most of the payments and securities flowed, and who are the backup source of credit to the securities markets. Because of its ongoing supervisory relationships and knowledge of the payment system's infrastructure, the Federal Reserve Bank of New York had the access, contacts, and in-depth knowledge of these institutions that enabled it to address this complex problem. The Fed understood the potential problems of Drexel's counterparties and clearing banks and had established close working relationships with key personnel. The Fed was able to use its knowledge and relationships to work with the banks and securities firms to identify developing problems, and fashion procedures that enabled securities to be transferred and credit to be extended to facilitate an orderly winding down of Drexel without adverse effects on innocent bystanders or adding to the overall fragility of the financial markets.

Another example of Federal Reserve involvement in crisis management is the record stock market break of October 19, 1987, a drop paralleled by similar price declines in all major stock markets of the world. These events represented a serious threat to the stability of the global financial system. Formulating and carrying out actions to maintain the integrity of the banking system, and thus limit the damage inflicted by the drop in stock prices, required a variety of skills and powers. Particularly crucial were the Federal Reserve's knowledge of financial markets, its contacts with foreign central banks and with U.S. securities and commodities regulators, and its experience with supervising and regulating banking institutions and the payment system, all working hand-in-hand with its monetary policy.

Perhaps most visibly, early on October 20, the Federal Reserve issued a statement indicating that it stood ready to provide liquidity to the economy and financial markets. In support of that policy, the Federal Reserve conspicuously and aggressively added reserves to the banking system on a daily basis through the end of the month. These actions were taken as a central bank and could have been taken without supervisory and regulatory authority.

However, the Fed's actions went far beyond the provision of reserves. The System took a number of other steps that drew on its expertise in the operation of markets and the payment system and in assessing the financial strength of important participants. These included increased surveillance of the U.S. Government securities market, and more frequent contact with participants and regulators at the Treasury and elsewhere. But a focal point of these actions was the banking system. Drawing on its supervisory experience, the Fed immediately assessed the funding and risk characteristics of major banking organizations to help identify any emerging problems. Federal Reserve examiners on-site in major banking institutions obtained information rapidly on potentially significant lending losses and emerging liquidity

pressures. Examiners were also sent into firms directly affected by an options dealer that had suffered large losses. To detect the development of any bank runs, the Federal Reserve monitored currency shipments to all depository institutions. Frequent contact with counterparts in other major financial centers kept both the Fed and foreign authorities informed about developments in markets and at international banks and other financial firms.

The credit relationships between banks and securities firms received particular attention. To obtain information about securities credit, the Federal Reserve, through its examiners, was in frequent contact with both banks and securities firms regarding the liquidity and funding of broker/dealers. Securities dealers' need for credit was expected to rise, but with substantial losses likely from the large drop in stock prices both firms and their customers would have less collateral to secure borrowing. In its discussions, the Fed recognized that banks needed to make sound credit judgments in the circumstances, but it also stressed the systemic problems that would develop if the credit needs of solvent, but illiquid, firms were not met.

Problems in the futures and options markets, in particular, illustrated the relationship between the banks and the securities firms, as concern grew that gridlock was being approached in the settlement systems of the Chicago exchanges after large margin calls on October 19 and 20. At the time, margin calls were collected through four settlement banks in Chicago. Clearinghouse members were unable to fund their accounts at the settlement banks in time to meet the margin calls. Owing to the unusual size of the margin calls to certain large clearing members, the settlement banks were unwilling to confirm those members' payments to the clearinghouse until they could verify that funds had been received to cover the payments from the New York banks at which the relevant clearing firms maintained their principal banking and credit relationships. At the same time, the New York bankers were already concerned about rumors regarding the creditworthiness of their customers and had little time to fully understand the exposures that the securities firms had across other lines of activity such as foreign exchange, risk arbitrage, and block trading. Telephone calls placed by officials of the Federal Reserve Bank of New York to senior management of the major New York City banks helped to assure a continuing supply of credit to the clearinghouse members, which enabled those members to make the necessary margin payments.

While it is difficult to determine how the situation would have evolved in the absence of these actions, it seems reasonable that the risk of even more disruptive developments would have increased. The Federal Reserve's ability to reach judgments about what actions were necessary depended critically on both its supervisory and its economic knowledge of financial markets, banking institutions, and payment systems and the Fed's credibility with market participants accumulated through many years of operating in the markets and supervising banks.

The collapse of State-chartered, privately insured thrift systems in the States of Ohio and Maryland in the mid-1980's were other incidents in which the Federal Reserve drew heavily on its supervisory resources and experience in carrying out its crisis management responsibilities. When the largest of 71 privately insured institutions in Ohio was reported to have suffered heavy losses due to fraudulent securities transactions, depositor runs were triggered at the affected institution and confidence in the viability of the insurance fund was undermined. These developments led to runs at many other institutions insured by the fund. Within 2 weeks, the Governor of Ohio had closed all of these institutions, and a law was then enacted that permitted their reopening only if they were able to obtain Federal deposit insurance.

Maryland's problems followed within months, as the collapse of the Ohio system raised concerns about the ability of the private insurer of 101 State-chartered savings institutions in Maryland to cover losses if they were to arise. Those concerns received confirmation when the two largest of these institutions were found to be insolvent due to fraud and other abusive practices. Once again, depositor runs at the insolvent institutions and at other institutions insured by the fund forced the closing of all, with their reopening conditioned on their being found eligible to access the Federal Reserve's discount window. Additionally, the State promptly enacted legislation that required these institutions to obtain Federal insurance, be merged with an insured institution, or to be liquidated.

Responding to requests for assistance from the governors of each of these States, the Federal Reserve assembled examiners from throughout the System—with a sizable contingent of examiners from the OCC and FDIC joining in the case of Maryland—to help resolve the crises. Under the Federal Reserve's general direction, examiners entered virtually all affected institutions in both States to evaluate assets that might serve as collateral for discount window loans, to monitor deposit outflows and currency drains from the institutions, and to assess their financial condition. Simultaneously, the Federal Reserve took steps to ensure that currency was strate-

gically placed in selected areas of each State to permit quick delivery to institutions experiencing heavy cash withdrawals. Because of these efforts, the System was able to extend discount window loans expeditiously when institutions encountered serious liquidity problems, to process checks, ACH payments, and the wire transfers of the institutions prudently and effectively, and to meet all requests for currency.

The Federal Reserve also served as advisor to State authorities and a facilitator of discussions with major depositories that sought to find solutions to these problem situations. In short, the Federal Reserve's broad mandate for economic stability, coupled with its operational experience in markets and supervision, played an instrumental role in resolving each crisis in as orderly a manner as possible, and effectively contained the potential for spillover effects on federally-insured depositories and other financial institutions.

A final example is the Mexican debt crisis of 1982, which marked the beginning of a generalized debt problem in the less developed countries in the 1980's that threatened the world's financial system and economic growth. The Federal Reserve recognized the potential for problems because of both its expertise and its intimate role in banking supervision. Bank and bank holding company supervisory reports and the judgment of Federal Reserve examiners provided vital information regarding the fact that exposures to countries that were susceptible to payments difficulties were well in excess of the capital of many banks. Not just the largest U.S. banks, but also many smaller banks were significantly involved; in total, more than 150 U.S. banks had exposure to Mexico. When the Latin American debt crisis broke publicly in 1982 with a potential default by Mexico on more than $50 billion in claims held by international commercial banks, the Fed was positioned to act quickly to organize the international provision of liquidity support while a more permanent solution was worked out. The Fed could respond quickly and comprehensively because of the practical knowledge gained from hands-on examination of banks, its deep involvement in the country-risk examination process, and its extensive contacts with foreign central banks.

After the initial phase of the debt crisis, tension developed between two seemingly conflicting considerations. On the one hand, the financial strength of the banking system needed to be protected and restored in light of the potential losses by banks on their exposures to developing countries. On the other hand, if at least conditional access by developing countries to funding from hundreds of U.S. and foreign banks was not maintained, those countries would not have been able to work out their problems in an orderly fashion. The collapse of those countries' ability to renegotiate their debts would have increased the likelihood of widespread bank failures in the United States and around the world, threatened the stability of the global financial and trading system, and worsened the already tenuous growth prospects of the industrial countries.

The Federal Reserve, by virtue of its combined responsibilities for oversight of the financial and the dollar payment systems on the one hand, and maintenance of macroeconomic stability on the other, was in a unique position to recognize these complex interactions and incorporate these considerations effectively in its supervisory actions. Through its active involvement in the daily supervisory process of a broad cross-section of U.S. banks, the Fed had the perspective and the knowledge to ensure that general supervisory policies, which often were initiated to deal with other concerns, did not impair overall efforts to resolve the LDC debt problem. Working with the Treasury and foreign central banks, the Federal Reserve understood that over an appropriate time horizon, considerations of financial prudence and macroeconomic stability were not, in fact, conflicting, but rather required the same patient responses. Indeed, the Fed took the lead in coordinating a response by the U.S. bank supervisory agencies that avoided overaction to the Mexican crisis. In particular, U.S. commercial banks were not penalized for their participation in a constructive solution to the systemic threat posed by that crisis.

This last experience illustrates a point anticipated earlier. An agency with the sole or primary goal of prudential supervision and regulation, and without responsibility for the economic consequences of its own actions, will of necessity tend to focus almost entirely on a narrow view of safety and soundness. It will be severely criticized by the Congress and others if a bank fails on its watch; it will not receive credit for avoiding other failures in unusual circumstances by being flexible. It will not have the market experts—the economists and other specialists who spend their careers understanding evolving institutions and instruments and how they react during adversity and crisis. It is the combining of the Fed's supervisory knowledge with that of these other experts *and* its broad macroeconomic responsibilities that facilitates—indeed, requires—the balancing of the prudential supervision of banks against the broader economic implications that surround a crisis.

Monetary Policy

While crises arise only sporadically, the Federal Reserve is involved in monetary policy on an ongoing basis. In this area, too, the Fed's role in supervision and regulation provides an important perspective to the policy process. Monetary policy works through financial markets to affect the economy, and depository institutions remain a key element in those markets. Indeed, banks and thrifts are more important in this regard than might be suggested by a simple arithmetic calculation of their share of total credit flows. While securities markets of different types handle the lion's share of credit flows these days, banks are the backup source of liquidity to many of the securities firms and large borrowers participating in these markets. Moreover, banks, at all times, are the most important source of credit to most small- and intermediate-sized firms that do not have ready access to securities markets. These firms are the catalyst for U.S. economic growth and the prime source of new employment opportunities for our citizens. The Federal Reserve must make its monetary policy with a view to how banks are responding to the economic environment.

Factors affecting banks, quite apart from monetary policy, can have major implications for their behavior and for the economy. Important among these factors are elements of the supervision and regulation of depositories. As Chairman Volcker noted in his testimony on the 1985 Bush Commission proposals for reform:

> Policies such as those affecting capital and liquidity standards, the "toughness" of examinations, loan-loss provisioning, and information disclosure can have great significance for the effectiveness of monetary policy as well as for the stability of the entire financial system. Conflicts will inevitably arise in these areas as they are approached from different perspectives. Those conflicts need to be resolved, and I believe the perspective of the central bank is one essential part of a satisfactory resolution.

An example of such a central bank perspective is the development of the rules the banking agencies impose on banks to implement Federal legislation and/or to further prudential supervisory goals. In the interagency development of such rules, the Fed brings to the table its unique concerns for the impact of the proposed rules on credit availability and the resultant consequences for the economy. Recent examples include the Fed's role in modifying the real estate appraisal and minimum loan-to-value regulations and the implementing rules of the non-capital "tripwires" in FDICIA. The Fed would not be able to exert sufficient influence to assure that economic consequences were properly considered if it had just a minority vote on a commission. It is the healthy tension of independent agencies coordinating their rules which permits the Fed to bring the economic implications of rulemaking into the process.

The crucial nature of economic considerations in the development of supervisory policy was illustrated most recently in the credit crunch. Banks realizing losses on commercial real estate and other credits were pulling back from all types of lending; their impulse to do so interacted in complex ways with the policies of regulators and supervisors responding to the situation. Certainly, a major factor in the Fed's decision to ease interest rates from 1989 on was its increasing awareness, importantly gained through the examination process, that banks were rapidly tightening their lending terms and standards. The Federal Reserve was never able to offset fully the lending trauma that led to the "credit crunch" of the early 1990's, but it clearly contained its deleterious effects in a significant way. Without the Fed's hands-on bank supervisory activities, it might not have been aware of the seriousness of this problem until later, with doubtless unnecessary strain on the economy.

The "credit crunch" experience also illustrates how Federal Reserve involvement in supervision and regulation can improve those functions as well. Its own experience in the banking system and the knowledge of its examiners were key elements in enabling the Fed to analyze this phenomenon and work closely with other agencies to adjust supervisory policies to alleviate the crunch while preserving safety and soundness. A central bank brings a unique and invaluable perspective to regulation; it is far better situated than a narrowly focused regulatory agency to see how bank regulation and supervision relate to the strength of the payment system, the stability of financial markets, and the health of the economy.

Payment System

The Administration's proposal for a single regulator recognizes the important role that the Federal Reserve plays in the payment mechanism. As noted earlier, however, the authority proposed for the Federal Reserve would be insufficient for the Fed to ensure a safe and sound payment system. To do so requires an ability to evaluate the fundamental strength of the banks that lie at the heart of the payment system and to retain personnel with the necessary broad perspective.

To understand the importance of the payment mechanism, one must realize that the dollar interbank payment system is the Nation's backbone for clearing and settling transactions in the Fed funds, Government securities, and corporate securities markets, as well as transactions generated by nonfinancial businesses and consumers. In addition, the dollar payment system is the linchpin of the international system of payments that relies on the dollar as the major international currency for trade and finance. Consequently, the foreign exchange and related markets rely heavily on settlements involving the U.S. dollar payment system. The key large dollar electronic payment systems, Fedwire and CHIPS, transfer nearly $2 trillion per day and thus these systems, as well as specialized depositories and clearinghouses for securities and other financial instruments, are crucial to the integrity and stability of our financial markets and our economy. In all these payment and settlement systems, commercial banks play a central role, both as participants and as providers of credit to nonbank participants. Day in and day out, the settlement of payment obligations and securities trades requires significant amounts of bank credit.

Moreover, in periods of stress, such credit demands surge and, if unmet, could produce gridlock in payment and settlement systems and bring a halt to activity in financial markets. As indicated in the 1990 Drexel failure, the 1987 stock market crash, and the 1982 Mexican debt crisis, ensuring the continued operation of the payment system often requires broad and complex knowledge of banking and markets, as well as detailed knowledge and authority with respect to the payments and settlement arrangements and their linkages to banking operations. This type of understanding and authority—as well as knowledge about the behavior of key participants—cannot be created on an *ad hoc* basis. It requires broad and sustained involvement in both the payment infrastructure and the operation of the banking system.

FOREIGN EXPERIENCE

Central banks in all but one G–7 country, in most cases *de jure* but always *de facto*, are closely involved with the supervision of banks in their countries and internationally. More broadly, the central bank has either total or shared responsibility for bank supervision in three-quarters of the nations in the OECD. In all industrial countries, either central banks or Finance Ministries, or both, are involved with supervision because nations have come to understand that bank supervision has economic consequences that are important for stability and economic growth. Of course, the specifics of each central bank's role vary from country to country, depending importantly on cultural and historical features, the institutional structure, and the degree of concentration of the financial system.

For example, bank supervision in London and Tokyo—the major international financial centers, along with New York—is quite different. The Bank of England, after a long history in which it supervised banks informally, is now the sole statutory supervisor of all institutions engaged in banking activities in the United Kingdom. The Bank's mode of supervision, with less reliance than in some other countries on on-site examinations, reflects the highly concentrated nature of the British banking system. The five largest banks account for nearly two-thirds of the sterling assets of the domestic offices of all British banks, far greater concentration than exists in the United States. In Japan both the Ministry of Finance and the Bank of Japan conduct regular on-site examinations of banks (in alternate years) and, more generally, share responsibilities for bank monitoring, analysis, and supervision. Whereas the Ministry's role is statutory, the Bank's role is contractual and is based on an individual agreement with each bank that uses its services. Interestingly, the Bank of Japan employs more bank examiners than the Ministry of Finance.

Germany provides still another model. The Federal Banking Supervisory Office (FBSO) is the primary banking supervisory body, but it exercises its authority in close coordination with the Bundesbank. Both the FBSO and the Bundesbank are authorized to conduct on-site examinations of banks, although both rely heavily in practice on reports of external auditors. These reports are submitted to the appropriate branch of the Bundesbank (or Landeszentralbank, analogous to a Federal Reserve Bank), which reviews them, pursues any follow-up issues with either the bank or its auditors, and prepares summaries. (As in Japan, the central bank in Germany employs more supervisors than the supervisory agency.) This information is then given to the Bundesbank in Frankfurt, which does a further review and, in turn, provides the reports and summaries to the FBSO. In addition, the Bundesbank has veto power over certain liquidity and capital regulations of the FBSO. Thus, as in the United Kingdom, in Germany, where the banking system is highly concentrated (the largest three German banks account for nearly 40 percent of total bank assets) and where close contact with only the largest banks might seem to be sufficient for

many purposes, the central bank, in fact, is substantively involved with the entire banking system.

None of these models of supervisory structure can be applied readily to the United States, where there is a dual banking system (with both Federal and State authority) with over 11,000 commercial banks in some 8,500 separate organizations, and with banking assets distributed across a vast country. The large number of small banks is unique to the United States and has characterized our Nation almost from its founding. The emphasis of small banks on community lending—especially to small businesses that have been the engine of growth in the United States—has become embedded in our culture. It has been an important factor in our development as a Nation. The associated emphasis on innovation and diversity that accompanies such a large number of banks has contributed to an economy that has given the Nation the highest standard of living and the most diverse, innovative, competitive, and among the best capitalized banking system in the world. The diversity in banking is reflected in, and supported by, the dual banking system and the decentralized regulatory structure that encourages it to flourish.

But whatever the national model, it is clear that central banks are importantly involved in the hands-on supervision of their own banks at home and abroad and also of the operations of foreign banks in their countries. This involvement derives directly from the fact that, because central banks are the ultimate source of liquidity, central banks are inevitably responsible for solving or containing systemic threats. Thus, what is at stake in the current debate is how the U.S. central bank in the future will be able effectively and efficiently to do its job.

A Single Bank Regulator

In our economic system, banks necessarily must take credit risks to finance their customers. Such risk-taking is a critical ingredient for economic growth, but creates the necessity to balance regulation to limit deposit insurance exposure with the economic function of banks. Tradeoffs are required and a zero bank failure rate implies that banks are not performing their proper role. We have recently seen how banks' reduction in their risk appetite as a result of FDICIA, new regulations, weakened capital, and large loan write-offs, contributed to a credit crunch and slower economic growth. Tradeoffs are tricky and a swing in either direction can create both short- and long-term problems.

In balancing such tradeoffs, consider the position of a single supervisory agency required by law to promote a narrow view of bank safety and soundness without any responsibility for the macroeconomic implications of its decisions. The examination and regulation of banks is an inexact science and open to quite a wide range of outcomes. But, significantly, examiners will be severely criticized if they have responsibility for a bank that subsequently fails, while receiving no applause for the high profits of banks under their purview. Such incentives and missions will inexorably lead to a bias against bank risk-taking. As a practical matter, instructions to examiners are not easily drawn. It is easy to write a rule to avoid all risk, but it is difficult to instruct an examiner to encourage "some" risk.

The Fed knows that too extreme a supervisory posture can lead to a credit crunch, with attendant growth constraints. In the early 1990's, it played a critical role in recognizing early what was occurring in the banking system and persuading the other agencies to modify their examination standards. But the Fed also knows the future cost of lax examination standards and avoided some of the examination policies of the early 1980's that contributed to the bank failures and deposit insurance fund losses of the late 1980's and early 1990's. The Federal Reserve Board notes with some pride that a 1991 *Staff Report* of the House Banking Committee found that from 1986 through mid-1991 State member banks had paid more insurance premiums than the gross losses to the fund from failures of State member banks, and concluded that banks supervised by the other agencies were ". . . less effectively supervised than the FRB supervised banks." The report added that, ". . . the FRB demonstrated the best supervisory performance by a substantial margin" in the Southwest, where most losses occurred.

This record suggests another potential problem of a single regulator with a narrow focus on safety and soundness. As noted above, such an agency has a long-term bias toward excessively tight supervision. But, it also would be likely to go through phases that shift too far in the other direction. This could occur either in response to the economic effects of its tight posture, a kind of oversteering, or in political response to the natural desire of the regulated to operate in the most unfettered way possible. Such pressures, as history suggests, are difficult to resist, especially by an agency in which the decisionmakers are appointed with some frequency. The Federal Reserve's successful record cited above reflects its far more consistent supervisory policy, regardless of fashions, fads, and cyclical developments.

A consolidated single regulator would deprive our present regulatory structure of what the Board considers to be an invaluable restraint on any one regulator conducting an inflexible, excessively rigid policy. The present structure provides banks with a method of shifting their regulator, an effective test that provides a limit on the arbitrary position or excessively rigid posture of any one regulator. Clearly, the pressure of a potential loss of institutions has inhibited excessive regulation and acted as a countervailing force to the bias of a regulatory agency to overregulate.

The dual banking system and multiple Federal regulators have facilitated diversity, inventiveness, and flexibility in our banking system, so important to a market economy subject to rapid change and challenge. The dual banking system has also provided a safety valve for inflexible Federal positions. In an understandable response to some excesses at the State level, especially for thrifts, the Congress in FDICIA called for restrictions on the ability of the States to provide expanded bank and thrift activities. But a single Federal regulator would—especially with the FDICIA provision—effectively end the dual banking system: It would become an empty shell if a State-chartered entity had no choice of Federal regulator or different asset powers. The dual banking system cannot survive consolidation at the Federal level. The Federal Reserve Board believes that would be a serious loss.

To be sure, the existence of more than one regulator raises the concern that, on occasion, banks will shop for benign regulators, leading to the "competition in laxity" that Chairman Burns warned about in the 1970's. This is a legitimate concern. However, the Federal Reserve's record as the most consistent regulator—one that focuses on the long-run economic consequences of its actions—is inconsistent with an agency that would promote and encourage competition in laxity; quite the contrary. In addition, any effort by either agency to weaken its long-run supervisory stance would be mitigated by statutory floors on the level of supervision and regulation. Moreover, because depository institutions perceived as lacking safety and soundness have elevated funding costs, tough, but reasonable, supervision is often considered an asset by banks and thrifts.

In addition to the option a bank now has to change its regulator by changing charter or Federal Reserve membership status, another equally important check and balance would be lost if the current regulatory structure were replaced by a single regulator. Through the Federal Financial Institutions Examinations Council (FFIEC), the agencies endeavor to adopt consistent rules and regulations. That process of sharing points of view and expertise has demonstrably improved the final product, tending to eliminate the extreme and unworkable positions, and assuring that the Fed's concerns about systemic and economic problems are considered. A consolidated single regulator would not benefit from this exercise and might well tend to be less receptive to modifications of a preliminary, and even more so, of an adopted final rule. In short, there is a kind of built-in arbitrariness that comes with a single regulator.

Some have suggested that other parts of the financial system have single regulators. The Board would note, however, that neither the Securities and Exchange Commission (SEC) nor the Commodities Futures Trading Commission (CFTC) are monolithic regulators of their industries. Both oversee numerous self-regulatory organizations, including the organized exchanges, the National Association of Securities Dealers, and the National Futures Association, that, in fact, do all of the supervision and much of the regulation under SEC and CFTC oversight. Indeed, since the cash and derivatives markets are parts of one integrated financial market, that market can be thought of as subject to two Federal regulators—the SEC and the CFTC. In fact, most of the position-taking firms in this market are both registered broker/dealers and futures commission merchants, and thus subject to the rules and regulations of both Federal regulators.

An Alternative Proposal

If a single regulator is preferred, the best candidate would be the Federal Reserve. It is independent. It has experience and expertise. It currently has a broader regulatory and supervisory scope than any of the other banking agencies. It deals with large banks and small, with bank holding companies, foreign banks, foreign operations of U.S. banks, other central banks, securities dealers, and with financial markets broadly. The Congress also has assigned it responsibilities for a broad array of consumer protection regulations. In short, the Fed has responsibilities for, and experience and expertise in, a wide range of financial institutions and markets. But, the Board would strongly oppose the Federal Reserve becoming a single regulator, just as it opposes any other agent of Government in that role. While a monopoly bank regulatory agency could enforce uniformity in bank examination and regulation, it would do so at great cost to the broader efficiency and flexibility of our financial system, and run the risk of unnecessarily creating an arbitrary and capricious

Federal bureaucracy. Banking supervision and regulation can benefit from the variety of viewpoints and checks and balances of a system of more than one Federal regulatory authority—a structure that preserves real meaning for the dual banking system. A system in which banks have choices and in which regulations result from the give and take involving more than one agency stands a better chance of avoiding the extremes of supervision and of finding a well-balanced consistent policy over time.

There are other ways, short of the creation of a single agency, to address the problems in the current system. The crux of the issue is duplicative examinations of banks. This problem could be eliminated by a regulatory system that maintained two Federal regulators, but provided that, in general, only one of those regulators supervised all of the depository entities in any banking organization. Undoubtedly, there are several approaches that preserve choice and retain a major role for the central bank. One approach that the Board supports has three parts:

- Reduction of the number of agencies with supervisory and regulatory power from four to two—a Federal Banking Commission and the Federal Reserve.
- Elimination of duplicative examinations.
- Establishment of one Federal supervisor for all the depository institutions in any single banking organization, regardless of the charter class of the individual entities.

Under this approach, the OCC and OTS would be merged and renamed the Federal Banking Commission (FBC). The FDIC would no longer examine healthy institutions, but would join in the examination of problem entities. The Fed would, as now, promulgate rules for the establishment of U.S. offices of foreign banks and foreign offices of U.S. banks. The FBC would determine permissible activities for national banks and Federal savings associations. The FBC would also be the supervisor for (1) all independent national banks and thrifts and (2) all depository institutions in any banking organization whose lead depository institution is a national bank or a thrift. The Fed would be the supervisor for (1) all independent State banks and (2) all depository institutions in any banking organization whose lead depository institution is a State-chartered bank. The supervisor of depository institutions would examine, take enforcement actions, establish operational rules, and act on applications for all the depository institutions under its jurisdiction, regardless of the banks' charter class. The statistical appendix provides data on the redistribution of banking organizations and assets that would occur under this alternative.

The Board has not yet adopted a position on the supervision and regulation of bank holding companies and their nonbank affiliates. There are two broad options, and a strong case can be made for each:

- Under the first option, all holding companies and their nonbank affiliates could remain under the Fed's jurisdiction, continuing to provide uniform rulemaking for competitive equity and a substantial role for the Fed in shaping the financial structure, so useful for stabilization and systemic risk purposes. This option would result in two regulators for about 1,650 banking organizations, because the lead bank has a national charter, of which 92 percent would be subject to very light Fed supervision because the latter entities have no nonbank activities.
- Under the second option, the jurisdiction of virtually all holding companies could be split between the Fed and the FBC on the basis of the charter class of the lead bank. However, for systemic risk reasons, jurisdiction over those holding companies and nonbank affiliates of banking organizations that meet certain criteria—such as size and payments and foreign activity—would be retained by the Fed, even if the lead bank of the organization had a national charter. Under this variant, only about 25 to 30 organizations with lead national banks would have two supervisors, depending on the criteria established. All other organizations would have only one supervisor/regulator for the entire organization.

A variant of the second option might retain Fed authority over permissible activities of all holding companies, in order to retain some of the benefits of option one. All other authority over holding companies under the second option would be exercised by the regulator of the lead bank except for the 25 or 30 large organizations with national lead banks. Under either option, the number of banking organizations subject to multiple regulators would drop sharply.

Whatever option may be adopted for holding companies, under the proposal, the Fed would retain supervision and regulation of (1) all foreign banks that operate a bank, branch, agency, or commercial lending affiliate in the United States, and (2) all U.S. nonbanking operations of these foreign banks. As with domestic bank holding companies, all U.S. banks, branches, and agencies of foreign banks would be supervised and regulated according to the charter of the largest depository operation. Of the almost 300 foreign banking organizations operating a banking business

in the United States, most engage in banking through State-chartered entities and thus would have only one U.S. supervisor (the Fed) for its entire operation. Almost 60, however, would have their U.S. banking operations supervised by the FBC because their principal banking operation is conducted through a federally-chartered entity or entities.

The criteria used by the Board in developing its alternative approach are: (1) to avoid a single monolithic Federal regulator; (2) to assure that banks have a choice of regulator; (3) to reduce or eliminate overlap and duplication; and (4) to maintain a hands-on role in banking supervision for the Federal Reserve. As discussed earlier, the Board believes that the Fed needs a presence sufficient to be able to meet its responsibilities for preventing crises and managing those that it cannot prevent. That requires knowledge from broad based, hands-on supervision and regulation and the ability to affect events—that is, to have authority.

The Board also believes it needs a window into banks of all sizes and in all geographic regions. This is a large country with diverse sets of banks to service the complex structure of our economy. Each set responds in a different way to economic developments; each set provides somewhat different information about the nature of its region or its customer base. A cross-section of banks of all sizes and locations provides important intelligence to the central bank about evolving economic trends and responses to shocks and policy changes. The global nature of our financial markets means that internationally active banking organizations are of particular importance to the central bank. Internationally active banks almost by definition create the potential for systemic risk. Disruptions or difficulties at one of these institutions could well have a significant impact on a wide range of other financial institutions, both domestic and international, and through them on the U.S. economy. This potential for systemic risk arises from the nature of internationally active banks: They are generally large and have subsidiaries or branches overseas; the U.S. branches of foreign banks, for example, are major participants in U.S. financial markets. The banks and their branches fund themselves actively in international money markets, where creditors are relatively quick to restrict funding to banks thought to be in trouble, and where the problems of one bank can easily affect funding to other banks from the same country. They are almost universally used by their customers and by other banks for clearing and settlement purposes, so that they are substantial participants in the payment system.

In order to meet its responsibilities, the Board believes that it must have an important role in the interface between banks and the financial system, a role that gives it information and influence backed up by enforcement authority. The Board thus proposes that it should continue to promulgate rules for the establishment of all U.S. offices of foreign banks and foreign offices of U.S. banks and supervise and regulate the holding companies and nonbank affiliates of all foreign banks; supervise and regulate either all holding companies and their nonbank affiliates or at least those whose lead subsidiary bank is State-chartered *plus* those of a small number of large and financially active banking organizations whose lead banks have a national charter; and supervise and regulate State member banks and, if the lead bank in a holding company is a State member, all their depository affiliates. The proposal also calls for the Fed to supervise and regulate State nonmembers and, if the lead bank in a holding company is a State nonmember, all their depository affiliates, with these banks being a significant *addition* to its regulatory load. This expansion of the Fed's supervisory functions results solely from the view that in a two agency structure it is desirable that there should be a clear delineation of supervision and regulation responsibility by charter class in order to preserve the dual banking system. The Board makes no case that responsibility for such banks—that account for almost one-quarter of bank assets—is needed for financial stability and monetary policy purposes. However, some critical mass of banks of various sizes and locations is required if the Fed is to perform its functions effectively.

In sum, this proposal would achieve essentially all of the benefits of one consolidated regulator while incurring virtually none of its risks. It eliminates duplicate supervision at all depository institutions, and greatly reduces overlapping regulation. It provides for one supervisor for all depository institutions in any banking organization—even though there are two supervising agencies. It maintains the dual banking system by providing for a separate Federal supervisor for State banks and permits any bank to change Federal regulator by changing charter, thus ensuring a set of checks and balances on the arbitrariness of a single regulator. It maintains the healthy process of dynamic tension in bank rulemaking. It maintains the practical knowledge and skill, and the influence and authority, of the central bank, so critical for crisis prevention, crisis management, and monetary policy, as well as the valuable perspective the central bank brings to supervision. In short, the proposal would avoid an inflexible, single regulator, preserve the dual banking system, as-

sure that an economic perspective is brought to supervision and regulation, and maintain a strong central bank.

Statistical Appendix: The Current and an Alternative Supervisory Structure of Banking Organizations in the United States

Table 1 displays the current organizational structure of the 11,000 commercial banks in the United States. Only about 3,000 of the commercial banks—somewhat over one-fourth—are independent, i.e., are not owned by a bank holding company (BHC). About one-third of the banks are subsidiaries of one-bank HC's that have no nondepository assets, i.e., BHC's that have no subsidiary other than that one bank. These "shell" HC's use the HC form mainly for tax and funding purposes. As can be seen in rows 2 and 4, the independents and one-bank HC's tend to be relatively small, accounting between them for over two-thirds of the banks, but only one-fourth of aggregate commercial bank assets.

Almost three-fourths of the bank assets are held by almost 500 multibank HC's (MBHC's) that own more than one bank and also own nondepository subsidiaries. About 340 MBHC organizations do not have *any* nondepository affiliates and hence their HC's are "shells"; these banks hold about 2 percent of bank assets.

As shown in the last two rows of table 1, most of the BHC's—about two-thirds—are shell one-bank HC's. As noted, the relatively small number of non-shell MBHC's (next-to-the-last column) account for the largest volume of bank assets. The holdings of nondepository assets by BHC's (not shown in the table) are also quite concentrated. Two-thirds of the nondepository assets of BHC's are held by 10 MBHC's; 80 percent by the top 20; 88 percent by the top 100. About 1,000 one-bank HC's and MBHC's own the $237 billion of nondepository assets of BHC's.

Tables 2 and 3 provide more detail on commercial banks and BHC's, by focusing on the charter class of the commercial bank and thrift subsidiaries, cross-classified (in the case of commercial banks) by the charter class of the lead (largest) bank. For example, as shown in the last two columns of table 2, the 301 MBHC's in which the lead bank is a national bank have 1,304 affiliated banks, 684 of which also have national charters and 620 of which have State charters; 536 of the latter banks are not members of the Federal Reserve and 84 are. As shown in the lower panel, these 301 MBHC's (there is only one lead per organization) own 44 thrift affiliates. Table 3 indicates that the 301 MBHC's with national lead banks have $1.8 trillion of bank assets ($1,092 billion plus $663 billion), or almost half of the $3.6 trillion of bank assets shown in the first column of that table. These MBHC's have thrift assets of $39 billion.

The Federal regulation of *each* corporate component of a banking organization is determined under current law by the charter class of that component, as shown in table 4.[1] Excluding the SEC, there are four Federal regulators of depository institutions (excluding credit unions): the Office of the Comptroller of the Currency (OCC); the Federal Reserve (FR); the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS). For *commercial banks* alone, the memo columns at the far right of table 4 indicate that the FDIC currently regulates the largest number of banks, the OCC the largest proportion of bank assets, and the FR the smallest proportion of banks and bank assets. However, the FR regulates and supervises all BHC's shown in table 1 and most foreign banking operations in the United States, shown in table 5. All of the international operations shown in the first panel of table 5 are included in tables 1 through 3; they are consolidated into the U.S. banking statistics. The middle panel contains data on U.S. branches and agencies of foreign banks *not* included in the consolidated worldwide assets of U.S. banks. Currently, the FR supervises the vast majority of the number and assets of such entities. Even though significant international banking operations in forms other than U.S. branches and agencies of foreign banks are currently supervised by other agencies, the Congress has directed the Federal Reserve to determine the rules for the establishment of U.S. bank operations abroad, all the rules for Edge Corporations, and—in FDICIA—required the Federal Reserve to approve all entry of foreign banking operations into the United States.

The existing regulatory structure means that a banking organization is now subject to one Federal banking supervisor only if it is (1) a single independent entity with no holding company; or (2) a BHC in which all the subsidiary banks are State-chartered members of the FR; or (3) a thrift HC with only thrift subsidiaries other than cooperative or industrial banks. A MBHC organization (whose parent is regulated by the FR) could be subject to four Federal regulators if the MBHC had national bank (OCC), State nonmember bank (FDIC), and thrift (OTS) subsidiaries.

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[1] State-chartered entities are also regulated and supervised by the State granting the charter.

While *each* component of a HC is subject to only *one* regulator, table 6 shows one measure of the degree of multiple regulation of banking and thrift *organizations*. The first two columns of the table reproduce the statistics used by the Treasury in November 1993, which show that 42 percent of U.S. depository institutions have one regulator, about the same proportion have two regulators, and 15 percent have three or four regulators. These data overstate the problem for the 4,200 shell one-bank HC's, which are included with those having two regulators: (1) the FR was apparently counted in error by the Treasury as the second regulator for the 359 BHC's with only State member subsidiaries; and (2) the FR on-site supervision of shell parents is far short of an examination. Since for shell HC's the bank subsidiary is the only entity of strong regulatory concern, most of these HC parents are inspected on-site only once every few years, with some companies going 5 to 10 years between inspections, depending on their previous rating, asset size, and volume of outstanding debt to the public. These inspections are also typically quite brief, requiring one or two individuals for 1 or 2 days on-site.

The last two columns of table 6 adjust the Treasury data by excluding the FR as a regulator for shell HC's and also by adjusting for minor definitional differences. These modifications suggest that, in fact, three-fourths of depository organizations—with 37.5 percent of aggregate depository institution assets—are effectively subject to only one regulator. While these adjustments may understate the overlap, to the extent of the minimal inspection time of shell HC's, the resultant statistics more accurately reflect the effective level of multiple regulation than do the Treasury data. Even these adjustments, however, do not change the fact that more than 15 percent of organizations, with over 45 percent of aggregate depository assets, are subject to three or more regulators.

To address this problem, the Federal Reserve's alternative would sharply reduce multiple supervision and produce one supervisor for all the depository institutions in any banking organization, while reducing the number of regulators from four to two and keeping the FR active in supervision. The rest of this appendix is a statistical summary of regulatory coverage under that approach—which is offered as an example of an option that meets the Federal Reserve's principles.

Two agencies—the FR and the Federal Banking Commission (FBC)—would divide between them the supervision (examining, enforcing, establishing operational rules, and considering applications) for all depository entities. The jurisdiction of each agency would be determined by the charter class of the lead commercial bank: The FBC would supervise (1) independent national banks and thrifts, and (2) *all* bank and thrift affiliates (regardless of charter) of organizations with lead national banks; the FR would supervise (1) independent State banks and (2) *all* bank and thrift affiliates (regardless of charter) of organizations with lead State banks. The FR would also supervise U.S. banks, branches, and agencies of those individual foreign banks in which the dominant volume of assets was at State-chartered entities, and the FBC would supervise all U.S. banks, branches, and agencies of those individual foreign banks in which the largest share of assets was held at federally-chartered entities (see memo to table 5).

If the Fed retained supervision and regulation of all holding companies, about 1,650 banking organizations—the about 1,350 national one-bank bank holding companies and the about 300 multibank holding companies whose lead bank has a national charter—would have two regulators: the Fed for the 1,650 holding companies and the FBC for the almost 3,000 bank subsidiaries. However, 92 percent of these holding companies are "shells" and, hence, subject to only minimal supervision by the Federal Reserve. If the supervision and regulation of holding companies were split between the Fed and the FBC on the basis of the charter class of the lead bank, with the Fed also retaining authority over the holding companies of certain large and active national bank holding companies, only the latter banking organization would be subject to dual supervision and regulation. The number of organizations subject to dual supervision would vary between 25 and 30 depending on the criteria used. Under either approach, the number of banking organizations subject to more than one regulator would be reduced sharply and none would have more than two.

Table 7 provides more detail on the *commercial banks* that would be regulated by the FBC either because the bank was (1) an independent national bank, or (2) a national bank subsidiary of a one-bank HC, or (3) in a MBHC in which the lead bank was a national bank.[2] Of the 3,745 banks that would be supervised by the FBC, 620 are State-chartered bank affiliates of MBHC's in which the lead is a national bank—536 State nonmembers and 84 State members. The banks that would

[2] The FBC would also supervise 43 thrifts that were affiliates of banks under their jurisdiction—in addition to the thrifts that are independent or in thrift HC's.

be supervised by the FBC accounted for more than one-third of all insured commercial banks and 57.5 percent of all bank assets as of September 30, 1993.

Table 8 provides similar data for the *commercial banks* that would be supervised by the FR either because the bank was (1) an independent State bank, or (2) a State bank subsidiary of a one-bank BHC, or (3) in a MBHC in which the lead bank was a State member or nonmember bank.[3] Of the almost 7,300 banks that would be supervised by the FR, 261 are national banks (117 in MBHC's in which the lead is a State member and 144 in MBHC's in which the lead is a State nonmember). The banks that would be supervised by the FR accounted for two-thirds of all insured commercial banks and 42.5 percent of all bank assets as of September 30, 1993.

About 85 percent of the banks that would be subject to FR supervision under the alternative proposal are allocated to the Fed because the Fed would be responsible for State nonmembers—State nonmember independents, State nonmembers in one-bank HC's, and all banks in MBHC's where the lead bank is a State nonmember. As shown in table 9—which summarizes the allocation of supervisory authority over all entities under the Fed alternative—only 10 percent of the universe of banks (with less than one-fourth of all U.S. bank assets) are at independent State members, State member one-bank HC's, or are banks in MBHC's in which a State member is the lead bank (see "State Member Lead" column, "Total Commercial Banks" row). The alternative proposal allocates all State banks to the Fed, rather than just member banks, because of the desirability of defining clearly Federal supervisory responsibility by charter class to preserve the dual banking system. The Fed, as noted in the text, makes no claim that nonmember banks are needed for stabilization or crisis management purposes. As a supplement to the large and financially active BHC's, the current Fed supervision of State member banks—large and small—provide a sufficient knowledge base for Fed policy purposes.

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[3] The FR would also supervise 102 thrift affiliates of HC's in which the lead bank is State-chartered.

Table 1
Organizational Structure
of
Federally Insured Commercial Banks
(As of September 30, 1993)

Entity Types	Structure					Total
		One Bank Holding Company		Multibank Holding Company		
	Independent (No HC)	Shell [1]	Other	Shell [1]	Other	
Commercial Banks						
Number	2,980	3,618	1,012	865	2,530	11,005
Percent	27.1	32.9	9.2	7.9	23.0	100.0
Commercial Bank Assets [2]						
Level (billions of dollars)	297	270	359	69	2,626	3,621
Percent	8.2	7.5	9.9	1.9	72.5	100.0
Bank Holding Companies						
Number [3]		3,619	1,011	341	494	5,465
Percent		66.2	18.5	6.2	9.0	100.0

NOTE: May not add to 100.0% due to rounding.

1. A shell HC owns no nondepository assets.

2. Consolidated worldwide assets. Excludes U.S. branches and agencies of foreign banks. Includes U.S. bank subsidiaries of foreign banks (which are treated just like any other U.S. bank); foreign branches, agencies, and subsidiaries of U.S. banks; and Edge subsidiaries of U.S. banks.

3. HCs measured as "top tier" and excludes 632 intermediate HCs that are subsidiaries of other HCs.

Table 2

Number of Insured Depository Institutions in the U.S.[1]

That are Independent Insured Commercial Banks or are in Bank Holding Companies[2]
as of September 30, 1993

	Total	Not in BHCs	One-Bank BHCs[3]	Multi Bank BHCs									
				Total State and National		State Bank Lead						National Bank Lead	
						Total State		Member Lead		Nonmember Lead			
				Lead	Affiliate	Lead	Affiliate	Lead	Affiliate	Lead	Affiliate	Lead	Affiliate
Commercial Banks													
State	7,619	2,194	3,276	534	1,615	534	995	86	256	448	739		620
Member	970	283	362	86	239	86	155	86	111		44		84
Nonmember	6,649	1,911	2,914	448	1,376	448	840		145	448	695		536
National	3,386	786	1,354	301	945		261		117		144	301	684
Total	11,005	2,980	4,630	835	2,560	534	1,256	86	373	448	883	301	1,304
Thrifts[4]													
Savings & loans	19		4		15		8		2		6		7
Federal	7		2		5		1		-		1		4
State	12		2		10		7		2		5		3
Savings banks	129		71	3	55	3	20		5	3	15		35
Federal	52		11		41		13		4		9		28
State	77		60	3	14	3	7		1	3	6		7
Other thrifts[4]	6		4		4		-		-		-		2
Total	154		79	3	72	3	28		7	3	21		44
Grand Total	11,159	2,980	4,709	838	2,632	537	1,284	86	380	451	904	301	1,348

1. Includes insured institutions in the 50 states of the United States and the District of Columbia as well as those in the U.S. territories and possessions.

2. Any organization with a banking subsidiary will be included in this table.

3. Based on number of insured commercial banks. If, for example, a BHC owns one insured commercial bank and one or more thrifts, it is considered to be a one bank holding company. BHCs that own state chartered savings banks and no commercial banks are considered to be BHCs under Regulation Y.

4. All thrifts in the lower panel are affiliated with BHCs. The charter class of the *thrift* determines its *row*. The charter class of the *lead bank* of the BHC that owns the thrift determines the *column* to which the thrift is allocated. There are two exceptions to column allocation by lead bank: (1) three multi-bank HCs are each composed of a savings bank lead entity, each with one savings bank affiliate and no commercial bank affiliates (none of which are organizations listed in Table 8); and (2) the thrifts affiliated with the 79 one-bank holding companies are not allocated by charter class of the lead bank. The six "other thrifts" are federally insured cooperative and industrial banks.

Table 3

Total Assets of Insured Depository Institutions in the U.S.[1,2]

That are Independent Insured Commercial Banks or are in Bank Holding Companies[3]

as of September 30, 1993

($ billions; may not add to totals due to rounding)

	Total	Not in BHCs	One-Bank BHCs	Multi Bank BHCs									
				Total State and National		State Bank Lead						National Bank Lead	
						Total State		Member Lead		Nonmember Lead			
				Lead	Affiliate	Lead	Affiliate	Lead	Affiliate	Lead	Affiliate	Lead	Affiliate
Commercial Banks													
State	1,561	237	363	650	311	650	148	513	82	137	66		163
Member	710	34	81	513	82	513	38	513	36		2		44
Nonmember	851	203	282	137	229	137	110		46	137	64		119
National	2,060	60	266	1,092	642		142		126		16	1,092	500
Total	3,621	297	629	1,742	953	650	290	513	208	137	82	1,092	663
Thrifts[4]													
Savings & loans	17		1		17		3		*		2		14
Federal	14		1		14		1		-		1		13
State	3		*		3		2		*		2		1
Savings banks	88		58	1	29	1	4		1	1	3		25
Federal	20		1		18		1		*		1		17
State	69		57	1	11	1	2		*	1	2		8
Other Thrifts[4]	1		1		*		-		-		-		*
Total	107		59	1	45	1	6		1	1	6		39
Grand Total	3,728	297	688	1,743	998	651	296	513	209	138	88	1,092	702

* Less than $500 million.

1. Includes insured institutions in the 50 states of the United States and the District of Columbia as well as those in the U.S. territories and possessions.

2. Assets are worldwide consolidated depository institution assets, although only assets in the U.S. were used for U.S. banks owned by foreign banking organizations.

3. Any organization with a banking subsidiary will be included in this table.

4. All thrifts in the lower panel are affiliated with BHCs. The charter class of the *thrift* determines its *row*. The charter class of the *lead bank* of the BHC that owns the thrift determines the *column* to which the thrift is allocated. There are two exceptions to column allocation by lead bank: (1) three multi bank BHCs are each composed of a savings bank lead entity, each with one savings bank affiliate and no commercial bank affiliates (none of which are organizations listed in Table 8); and (2) the thrifts affiliated with the 79 one-bank holding companies are not allocated by charter class of the lead bank. The six "other thrifts" are federally insured cooperative and industrial banks.

Table 4
Federal Regulator
of
Corporate Components of U.S. Banking Organizations

Entity	Regulator	Memo: Percent of aggregate commercial banks	
		Number	Assets
National Banks	OCC	30.8	56.9
State Banks			
Members	FR	8.8	19.6
Nonmembers	FDIC	60.4	23.5
Savings Banks	OTS/FDIC/FR		
Savings and Loan Associations	OTS		
Cooperative Banks	FDIC/FR		
Industrial Banks	FDIC (if insured)		
Section 20 Affiliates	SEC/FR		
BHCs	FR		
Thrift HCs	OTS		
Memo: Foreign Operations			
Edge Corporations	FR		
U.S. Offices of Foreign Banks			
State Charter	FR		
National Charter	OCC/FR (residual)		
Representative Offices of Foreign Banks	FR		

Table 5
Foreign Bank Operations in the United States
and
U.S. Bank Operations Abroad
(As of September 30, 1993)

ENTITY	Supervised By			TOTAL
	FDIC	OCC	FR	
Included in U.S. Consolidated Worldwide Assets				
U.S. Bank Subsidiaries of Foreign Banks				
Number	61	25	8	94
Assets (billions of dollars)	74.1	67.5	20.4	162.0
Edge Subsidiaries of U.S. Banks				
Number [1]			70	70
Assets (billions of dollars) [2]			115.4	115.4
Foreign Branches and Agencies of U.S. Banks				
Number	37	261	93	391
Assets (billions of dollars) [3]	11.6	141.6	77.9	231.0
Foreign Bank Subsidiaries of U.S. Banks				
Number	1	5	20	26
Assets (billions of dollars) [3]	0.1	1.3	22.1	23.5
Excluded from U.S. Consolidated Worldwide Assets				
U.S. Branches and Agencies of Foreign Banks				
Number	34	71	464	569
U.S. Assets (billions of dollars)	7.4	44.3	632.2	683.9
	Supervised By			TOTAL
MEMO:		FBC	FR	
U.S. Branches and Agencies of Foreign Banks Calculated as in Alternate Proposal [4]				
Number		85	484	569
U.S. Assets (billions of dollars)		52.3	631.6	683.9

1. Represents the number of Edge corporations that are (1) engaged in banking and owned by U.S. banks; and, (2) engaged in investment activities through the majority ownership of foreign subsidiaries. (Number of Edges owning foreign subsidiaries is as of 12/31/92.)
2. Represents (1) aggregate claims on non-affiliates of Edge corporations engaged in banking and directly owned by a U.S. bank and (2) aggregate claims on non-related organizations of foreign subsidiaries of Edge corporations. (Foreign subsidiaries of Edge corporations are as of 12/31/92.)
3. Represents claims on non-related organizations as of 12/31/92.
4. Agency that supervises the largest share of the assets of the U.S. branches, agencies or banks of an individual foreign bank would supervise all of such offices of that bank.

Table 6
Number of Federal Regulators
for
Consolidated U.S. Depository Organizations [1]

	Originally Reported by U.S. Treasury [2]		Adjusted to Exclude Shell BHCs [3]	
	Percent of		Percent of	
Number of Regulators	Institutions	Aggregate–Depository Assets	Institutions	Aggregate–Depository Assets
1	42.0	27.0	74.1	37.5
2	43.0 [4]	26.0 [4]	10.4	17.1
3	13.0	27.0	12.6	23.9
4	2.0	20.0	2.9	21.5

1. An organization is an independent commercial, savings, cooperative, or industrial bank; an independent savings and loan association; or a "family" of banks and/or thrifts and their HC.

2. As reported in "Consolidating the Federal Bank Regulatory Agencies," U.S. Treasury, November 23, 1993.

3. A BHC with no non–depository subsidiaries. Minor adjustments for other definitional reasons.

4. Apparently includes in error 359 BHCs with only member bank subs, raising the insitutional coverage by 2.6 percentage points and the assets by 1.3 percentage points.

Table 7
Alternative Proposal

Commercial Banks that Would be Supervised by the Federal Banking Commission

(As of September 30, 1993)

Entity	Number of Banks	Assets (billions of dollars)	Percent of Total Insured Commercial Banks	
			Number of Banks	Assets
National Banks not in BHCs	786	60	7.1	1.7
National Banks in one bank BHC	1,354	266	12.3	7.3
National Bank is Lead in MBHC				
National Bank Lead	301	1,092	2.7	30.2
Affiliated Banks				
State Nonmember	536	119	4.9	3.3
State Member	84	44	0.8	1.2
National	684	500	6.2	13.8
Total	1,605	1,755	14.6	48.5
TOTAL	3,745	2,081	34.0	57.5

Table 8
Alternative Proposal
Commercial Banks that Would be Supervised by the Federal Reserve
(As of September 30, 1993)

Entity	Number of Banks	Assets (billions of dollars)	Percent of Total Insured Commercial Banks: Number of Banks	Percent of Total Insured Commercial Banks: Assets
Not in BHC				
State Member	283	34	2.6	0.9
State Nonmember	1,911	203	17.4	5.6
Total	2,194	237	20.0	6.5
In One Bank BHC				
State Member	362	81	3.3	2.2
State Nonmember	2,914	282	26.5	7.8
Total	3,276	363	29.8	10.0
State Nonmember is Lead in MBHC				
State Nonmember Lead	448	137	4.1	3.8
Affiliated Banks				
State Nonmember	695	64	6.3	1.8
State Members	44	2	0.4	*
National	144	16	1.3	0.4
Total	1,331	219	12.1	6.0
State Member is Lead in MBHC				
State Member Lead	86	513	0.8	14.2
Affiliated Banks				
State Nonmember	145	46	1.3	1.3
State Member	111	36	1.0	1.0
National	117	126	1.1	3.5
Total	459	721	4.2	20.0
TOTAL	7,260	1,540	66.0	42.5

Table 9
Alternative Proposal

Summary of Coverage of Examination, Enforcement, and Applications by Agency

(As of September 30, 1993)

Entity	FBC (National Bank Lead)	FR		Total
		State Non–member Lead	State Member Lead	
(Percent Distribution of Number)				
National Banks	92.3	4.3	3.5	100.0
State Nonmember Banks	8.1	89.8	2.2	100.0
State Member Banks	8.7	4.5	86.8	100.0
Total Commercial Banks	34.0	55.9	10.0	100.0
Thrifts (includes Industrial and Cooperative Banks)	98.7	1.0	0.3	100.0
(Percent Distribution of Assets)				
National Banks	93.1	0.8	6.1	100.0
State Nonmember Banks	14.0	80.6	5.4	100.0
State Member Banks	6.2	0.3	93.5	100.0
Total Commercial Banks	57.5	19.4	23.1	100.0
Thrifts (includes Industrial and Cooperative Banks)	99.3	0.1	0.6	100.0

PREPARED TESTIMONY OF EUGENE A. LUDWIG

COMPTROLLER OF THE CURRENCY, WASHINGTON, DC

Summary

We face a serious governmental and national problem that cries out for a prompt solution. Our system of multiple Federal supervisors for banks and thrifts failed us when we most needed it, as evidenced by the massive wave of bank and thrift failures in the 1980's and the ensuing credit crunch that contributed to the severity of the last recession. The cost to the American economy runs in the tens of billions of dollars. When put to another test, I fear that our supervisory system might well fail us again, at possibly an even greater cost.

We can better see why our supervisory system failed us by taking a closer look at how it threatens the long-run viability of banks and thrifts. Multiple supervisors have saddled those institutions with reporting and regulatory requirements that have been needlessly late and confusingly different and with supervisory requirements that are needlessly duplicative. Despite that duplication, we do not examine banks and thrifts as integral parts of the basic holding company that owns them. Consequently, there is always the danger in holding companies of a supervisory issue falling between the cracks.

The current supervisory structure also permits supervisors to avoid accountability for their actions. As matters now stand, it is never entirely clear which agency is responsible for problems created by a faulty, or overly burdensome, or late regulation. That means that the Congress, the public, and depository institutions themselves can never be certain which agency to contact to address problems created by a particular regulation.

These are not just my concerns. Over the years, many have tried to warn us about these flaws. Study after study, by the Congress, by a variety of Administrations of both parties, and by a series of independent commissions, have documented them. A large number of Senators, Representatives, and Federal supervisors clearly believe that structural flaws in our supervisory system severely threaten effective supervision. This is not a partisan issue.

While some of my colleagues in the supervisory community have other views, I believe the best way to secure these benefits is to follow the approach in the Senate, House, and Administration bills—combine all Federal supervisory authority over banks and thrifts in a single, independent Federal agency.

With a single Federal supervisor—a Federal Banking Commission (FBC)—we will have:

- accountability;
- a more efficient decisionmaking process; and
- more consistent supervision.

The reform proposals we are discussing today will also preserve and enhance both the dual banking system and the strength and independence of the FDIC and the Federal Reserve.

Under the single, Federal supervisor envisioned by the Administration, State supervisors would retain the rights and authorities they have today and remain the primary supervisor of the banks that they charter. In qualifying States, the FBC would not duplicate examinations of small, well-run institutions conducted by State authorities.

The FDIC would continue to be the Federal insurer of bank and thrift deposits and the receiver and liquidator of failed depositories; it would retain its "backup" enforcement authority, and it would have full access to all supervisory information at the disposal of the FBC.

The Federal Reserve would be able to meet fully all of its core functions. As a member of the FBC, it would have speedy access to all the supervisory information it needs, and it could participate in examinations conducted by the FBC of the largest banking organizations and a cross-section of small, State-chartered banks.

Introduction

Mr. Chairman and Members of the Committee, thank you for this opportunity to present my views on why we must reform the way we supervise banks and thrifts.

Yesterday, Secretary Bentsen outlined for you the Administration's proposal for achieving the much-needed and long overdue improvements in our Federal approach to supervising banks and thrifts. Both you, Mr. Chairman, and Senator D'Amato have joined forces to champion reform with your own initiative, and I am heartened by this considerable degree of common understanding, which is shared by Chairman Gonzalez and many Members of the House Banking Committee.

Among all of those who have earned our commendation with these initiatives, I believe that Secretary Bentsen deserves special recognition. He has put forward a plan calling for a decrease, not an increase, in the power and prestige of the Treasury Department. Under the Administration's proposal, the Treasury would relinquish its traditional institutional instruments for banking regulation and supervision—the Office of the Comptroller of the Currency and the Office of Thrift Supervision. Believing that agency consolidation is the only way to achieve excellence in supervision, he has taken a step rarely taken by past Administrations: recommending a change that brings himself and the institution he heads less, rather than more, authority.

This step taken by Secretary Bentsen surely underscores the fact that we face a serious governmental and national problem that cries out for a prompt solution. Here is how I see the dimensions of that problem.

When I first took office, I set out to find the root causes of the supervisory failures that so plagued us in recent years and to work toward eliminating them. I consulted many experts outside the Comptroller's Office, including the heads of the Federal banking and thrift agencies. They all stated, in one way or another, that the Federal system for supervising banks and thrifts is seriously flawed.

Experiences by staff at the Office of the Comptroller of the Currency (OCC) supported that diagnosis. Many of them shared with me their own frustrating dealings with the current system and those of their colleagues, both present and past. Those experiences contained valuable lessons. The OCC has been supervising banks for 130 years, and although we have made some mistakes along the way, we have learned a great deal about how best to supervise banks.

Finally, I drew upon my own personal experiences on both sides of bank supervision—representing banks and supervising banks—and they simply confirmed the judgments of others.

Now, as I look back over the last 10 to 15 years, I am convinced that our current supervisory system contributed significantly to a series of crises that inflicted massive harm upon our entire economy. The extent of the S&L crisis was surely exacerbated by a poorly equipped Federal Home Loan Bank Board (FHLBB). Designed to supervise a single type of depository institution that changed little and operated in a stable interest rate environment, the FHLBB did not have the breadth or depth of resources it needed to supervise thrifts effectively as they tried to expand their service offerings, when interest rates were moving erratically. The massive wave of bank failures in the 1980's and the ensuing credit crunch that contributed to the severity of the last recession was surely fed by our system of multiple Federal supervisors. As I will describe in greater detail shortly, that system is poorly suited for the timely development and implementation of crucial regulatory and supervisory initiatives.

We should not be surprised by the finding that our current supervisory system has so much potential for great harm. Over the years, many have tried to warn us about its flaws. Study after study, by the Congress, by a variety of Administrations of both parties, and by a series of independent commissions, have documented them.[1]

While there clearly remains significant differences to be resolved concerning the preferred model for restructuring, there is, to my knowledge, no disagreement about the basic facts—our supervisory structure is too complex, unnecessarily redundant, and too costly. A large number of Senators and Representatives believe that structural flaws in our supervisory system severely threaten effective supervision. Current members of the supervisory community, including current members of the Board of Governors of the Federal Reserve System, such as Chairman Greenspan and Governor LaWare, and former members, such as Andrew Brimmer, Jeffrey Bucher, and J.L. Robertson have all pointed out the need for reform, as have former Federal bank and thrift supervisors such as John Heimann, William Seidman, H. Joe Selby, and Timothy Ryan. Other public figures who have spoken out in favor of reform include former Treasury Secretary Donald Regan and former SEC Chairman Richard Breeden. Those currently in the private sector also advocating reform include Lawrence Connell, co-Chair of the Shadow Financial Regulatory Committee,

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[1] Virtually every study of our Federal banking regulatory system since 1949 has recognized the need for major consolidation. Proponents of consolidation have included a task force of the Commission on Organization of the Executive Branch of Government, commonly known as the Hoover Commission (1949); the Commission on Money and Credit (1961); House Banking Committee Chairman Wright Patman (1965); the Hunt Commission (1971); the House Banking Committee's Study of Financial Institutions in the Nation's Economy (1975); Senate Banking Committee Chairman Proxmire (1975); the Private Survey on Cost Control, commonly known as the Grace Commission (1983); Vice President Bush's Task Group on Regulation of Financial Services (1984); and the Bush Administration (1991).

former Connecticut Banking Commissioner, and former head of the National Credit Union Administration, and banking lawyer John D. Hawke, Jr., former General Counsel of the Federal Reserve Board of Governors. Clearly, this is not a partisan issue.[2]

There is also basic agreement about the direction in which we must move to fix the supervisory system—put Federal supervision in the hands of fewer Federal supervisors, and do so in a way that provides us with what we all have a right to expect: safe and sound depositories in full compliance with civil rights and consumer protection laws and a strong dual banking system. While some of my colleagues in the supervisory community have other views, I believe the best way to secure these benefits is to follow the approach in the Senate, House, and Administration bills—combine all Federal supervisory authority over banks and thrifts in a single, independent Federal agency.

I also believe we must proceed quickly. Our supervisory system has failed repeatedly in the past decade. These failures have imposed costs on the American economy that run in the tens of billions of dollars. When put to another test, I worry that our supervisory system might well fail us again. Although the banking system is currently highly profitable and generally well-capitalized, it faces new realities—an unprecedented combination of challenges that threaten its capacity to remain strong and vital over the long term that give a special sense of urgency to the need for reform.

THE NEW REALITIES

The new realities facing banks and thrifts can be viewed as two powerful economic forces pulling depositories in opposite directions. At the moment, depositories are in the midst of a powerful cyclical recovery. During the early phases of this recovery, a favorable interest rate environment boosted profits. More recently, a steadily improving economy has kept profit gains on track; improving credit quality has enabled depository managers to reduce provisions for loan losses and increase capital.

Structural change in the banking and thrift industries should also help to maintain profit trends, for a while. Consolidation of the banking industry continues unabated, forcing the weaker players from the market. This consolidation, buttressed by recollections of credit losses stemming from unwise underwriting standards, could produce somewhat more rational pricing in the 1990's than we saw during much of the 1980's.

Nonetheless, a long-term secular decline seems to threaten the very survival of banks and thrifts. Between 1972 and 1992, the share of credit market assets held by banks, S&L's, and savings banks fell from nearly 62 percent to 36 percent. That 26 point decline over two decades is deeply troublesome for the employees, managers, and owners of those depositories and also troubles those of us who set the public policy that guides the operation of those businesses. To what extent does that decline reflect inappropriate or inefficient regulation? Indeed, to what extent does it reflect an inappropriate or inefficient supervisory structure?

No one can be sure how long current positive trends will continue to counteract the long-term secular decline. Yet, by their very nature, these recent developments are transitory and sure to fade. History tells us that interest rate environments and the economy have their ups and downs; consolidation cannot go on forever. We should not risk waiting for other favorable developments to take their place.

We also must face a second new reality—the fact that our supervisory structure has begun repeatedly to fail us when we most need it. During the 1980's a series of adverse economic events—crises in agriculture, energy, and real estate, plus a recession—severely tested that structure. The consequent failure of thousands of depositories laid bare its weaknesses. The checks and balances that many saw as a main advantage of multiple regulators did not offer the protection that we needed.

Congress responded to the failure of our system by enacting the Federal Deposit Insurance Corporation Improvement Act (FDICIA). The substantial improvements brought by that legislation strengthened, but did not, indeed could not, repair the flawed structure. Realizing the full benefits of FDICIA demands a greater degree of harmony among Federal supervisors than they have ever achieved—perhaps greater than they ever could achieve. For no matter how hard we try, we cannot seem to overcome the differences in priorities, perspectives, and constituencies that are built into our supervisory system. If harmony is what we seek, we cannot patch, but must rebuild, our supervisory system.

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[2] Please see the attached addendum for selected statements on our supervisory structure made by those cited here.

OUR FLAWED SUPERVISORY SYSTEM: WHERE AND WHY

We can see the flaws in the current supervisory system most clearly in the results of interagency efforts to achieve agreement in each of the three key areas upon which sound supervision rests: reporting, regulatory prescriptions, and supervisory practices. I will discuss each of those areas in turn. As you will see, in all three areas, our current system too often yields results that are needlessly late and "second best." The industry and the entire economy have paid the price.

Mr. Chairman, as I share these observations with you and the Committee, I hope that you will keep two points in mind. First, I do not mean to imply that decisions by supervisors affecting the reporting by, and the regulation and supervision of, depository institutions should be instantaneous. Far from it. We would all agree that we want a responsive supervisory structure that gives us thoughtful, considered action. However, our current supervisory structure has pushed us far beyond the realm of meaningful debate and into meaningless and costly delay. Second, and equally important, these observations are commentaries on our supervisory structure and not on the people who must try to make it work. These people face a truly enormous task and deserve our respect and our thanks. If it were not for the fact that we have intelligent, highly motivated, and hard-working people at all the supervisory agencies, our supervision would be far less effective.

Bank Reporting

Let me first discuss the Call Report.

No document has had as long and tortured route toward uniformity than the Call Report. The Call Report is a lengthy presentation of assets, liabilities, income, and expenses that all banks must file with Federal banking authorities.

There were vast differences in Call Reports filed by national banks, State nonmember banks, and State member banks as late as the mid-1960's. In fact, the discrepancies were so galling to bankers at that time that they urged President Johnson to intervene on their behalf and demand that the Federal banking agencies work to hammer out a common document. He did, and the agencies responded by forming the Interagency Call Report Committee. Its major purpose was to work toward a uniform Call Report.

Progress was slow, and about 14 years later in 1978, Congress entered the fray and passed the Federal Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) that, among other things, called upon the banking agencies to work toward a common Call Report. To help the agencies along, Congress called upon them to establish the Federal Financial Institutions Examination Council (FFIEC), which Congress directed to coordinate the achievement of uniformity. A full 10 years later, in the late 1980's, the goal of a Call Report that was uniform across Federal supervisors had all but been reached.

The costs of such a long and drawn out process must surely have been substantial. First, the delay meant that bank holding companies with banks supervised by more than one Federal supervisor could not establish a single, cost-efficient data storage and retrieval system for filling out the Call Report. Until we achieved uniformity, they had to have more than one system and maybe three—one for the OCC, one for the FDIC, and one for the Federal Reserve.

Second, we cannot be sure that the uniformity we have now is efficient, in the sense that it represents the minimum amount of data that the agencies need from banks of various sizes. There is a natural tendency to avoid confrontation in the drive for uniformity by not vigorously opposing each other's suggestions for keeping or adding Call Report items, rather than giving careful attention to the true need for information for supervisory purposes. As shown by the chart at the end of this testimony, the number of different items filed by banks with assets under $100 million doubled over the last 9 years, from 320 items to 762 items.

Bank Regulation

Let me now turn to the subject of regulation.

Under specific and general grants of authority by Congress, the banking agencies issue regulations to implement Federal laws. These regulations cover a vast array of issues, and many do not require the agencies to act in concert. For example, the FDIC has regulations governing deposit insurance rates and the Federal Reserve has regulations governing deposit reserve requirements. These are unique to their individual responsibilities and do not involve the OCC or each other.

When Congress has deemed uniformity appropriate, it has taken one of two possible approaches. In some cases, Congress has granted rule-writing authority to a single Federal banking agency, with the understanding that the other agencies will enforce the rule in the banks that they supervise. The Federal Reserve, for example, has exclusive authority to write the "Truth-in-Lending" regulations. In other in-

stances, FDICIA, for example, Congress explicitly required the Federal agencies to write uniform regulations.

At times, Congress has not been so specific, but the agencies have realized, as in the case of CRA, for example, that a nearly uniform regulation was the only appropriate course of action.

Congress has not always insisted on uniformity. Up until FDICIA, one area Congress left to the Federal regulators was that of bank capital adequacy. Not until the late 1970's—over 60 years after the establishment of the Federal Reserve and over 40 years after the creation of the FDIC—did the agencies even begin to work on a common approach to something as fundamental as bank capital adequacy. Today we have common guidelines for assessing the adequacy of capital at individual institutions, but it took more than 10 years—and considerable prodding by Members of this Committee, among others—before we gained even this measure of uniformity. Even now, we have a long way to go.[3]

Were we to reach agreement on current matters, our labors would not be over. Amending the capital guidelines to reflect new developments in the marketplace remains a tortuous process, at best. Over the past 4 years or so, the agencies have been negotiating language for a proposed rule to guide bank use of asset securitization. Even after the agencies publish the proposed rule, we will still have much to negotiate.

Delays in issuing regulatory policies and the possibly less than optimal quality of interagency policies are not the only costs of having multiple Federal supervisors. The current regulatory structure permits regulators to avoid accountability for their actions. As matters now stand, it is never entirely clear which agency is responsible for problems created by a faulty, or overly burdensome, or late regulation. That means that Congress, the public, and depository institutions themselves can never be certain which agency to contact to address problems created by a particular regulation.

As a result, in many instances, Congress and the public must address their concerns about problems with a regulation to all four bank and thrift supervisors. Yet, even when they do that, they can never be certain their concerns will be addressed.

Why is it so difficult to reach interagency agreement? Why does it take so long? Several factors come into play. Knowledgeable people of good will inevitably have differences of opinion that must be ironed out; that is certainly true for both the staffs and heads of the four bank and thrift supervisory agencies. We do not want reform to come at the cost of stifling such debate. The new supervisory structure must be sensitive to, indeed, encourage, the careful consideration of diverse points of view. That sensitivity and encouragement will help ensure that it is fully responsive to needs of banks and thrifts and the customers they serve.

We should not, however, have much tolerance for delay that is due to some other factors. For example, the four agencies have long histories of independent action that have hardened their resistance to accommodating opposing points of view—resistance that the FFIEC has not been able to overcome. In those circumstances, debate among the agencies can take on the aura of deliberations among sovereign powers that have great difficulty reaching closure on almost any issue within meaningful time frames.

Those institutional forces of delay are often compounded by other factors. Interagency negotiations are conducted by staff members who represent agency heads with distinct, and strongly held views. These staff members often lack detailed instructions on the views of their principals, and they may be forced to infer how their principals might respond to staff-level proposals from the other agencies. In too many interagency negotiations, discussions are dragged out and decisions postponed while agency staffers check with their principals on each detail of the proposed policy.

A third factor also promotes delay. The different supervisory agencies may have competing priorities that shape their views of appropriate supervisory policy. For example, the FDIC's views of supervisory policy reflect concern about risks to the Bank Insurance Fund (BIF), while the Federal Reserve may be concerned about the impact of supervisory policy on monetary policy or the payments system. These com-

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[3] The common guidelines mask continuing underlying differences. FDICIA requires the Federal agencies supervising banks and thrifts to file annually, with the Congress, reports that describe their differences in their respective treatment of capital and accounting standards. The last report filed by the OCC described differences in 27 areas. See, "Differences in Capital and Accounting Standards Among the Federal Banking and Thrift Agencies" as published in the *Federal Register*, vol. 58, no. 47, at 16375.

peting priorities can make it all but impossible for the agencies to reach agreement on some supervisory policies.[4]

The costs of delay might be acceptable, were it not for the fact that in our world of fast-paced technological innovation, depository institutions must compete with businesses that are far less regulated. These businesses are much better positioned than banks or thrifts to hone their competitive edge through the effective management of new technologies that permit them to move money and information at virtually the speed of light. In this environment, banks and thrifts cannot be effective competitors if the supervisory structure that guides them is inappropriately slow afoot.

As in the area of bank Call Reports, congressional demands for uniformity in regulations will not repair our flawed supervisory structure. Even when Congress has insisted upon uniformity, it has not come easily, and the resulting compromises have often yielded less effective results than Congress or others might have intended.

The Administration's proposal to create a single Federal Banking Commission (FBC) would go a long way toward achieving uniformity. The FBC would not be encumbered with competing institutional histories, sovereignties, or priorities. At the same time, its own staff and its own leadership and their continuing contact with banking and other communities would help ensure its sensitivity to diverse points of view.

Bank Supervision

Finally, I want to say a few words about supervision.

Even when we have them, uniform regulations do not, of course, guarantee uniform supervision. By supervision I mean the evaluation of the day-to-day operations of banks and the imposition of corrective actions, when bank performance warrants them. Disparate supervision across the Federal agencies can range from different standards for assessing credit quality to different standards for assessing the quality of bank operating procedures.

For the managers of holding companies owning a variety of banks, the costs of disparate supervision can be great. It can be difficult to manage individual banks efficiently when the supervisory standards faced by one bank are not the same as those faced by another. At the end of last September, 413 holding companies, with assets over $2.4 trillion—52 percent of all assets held by banks and thrifts—were confronting this problem every day of the week.

Recently, I asked my staff to report to me on the type and degree of examination overlap in bank holding companies owning prominent national banks. The degree of inconsistency from one institution to the next surprised even me. In some cases, examiners attempt to keep supervisory burdens to a minimum by conducting joint examinations, sharing examination reports, and conducting joint meetings with holding company management. In other cases the sharing is not so great. In some companies, there is little, if any, sharing, and the holding company must send large packets of the same information to separate teams of examiners and meet separately, within relatively short periods of time, with examiners from different agencies.

Mr. Chairman, our supervisory system, which encourages such duplication and inefficiency, is obviously ill-equipped to deal effectively with the large number of integrated financial services organizations that populate the global marketplace. Within such holding companies, all banks and their nonbank affiliates must be viewed as if they were departments of a single organization working together toward a single objective and not as separate businesses pursuing individual business plans. Transactions among these "departments" can take place several times a day at near lightning speed and involve millions of dollars. We cannot obtain a true picture of the entire operation by looking solely at the transactions of one or two of its parts. Integrated firms demand integrated supervision.

As matters now stand, we must make do with a supervisory system built to handle the activities of institutions that have little to do with one another and go their separate ways. That can be costly. Because of competing jurisdictions, there is always the danger of supervisory issues falling between the cracks. One supervisor may see a transaction or series of transactions that could spell trouble for an entity in the jurisdiction of another supervisor. On some occasions, those seeing the trans-

[4] One example of conflicting priorities the Federal Reserve used to face deals with its own Regulation Q, which set ceilings on how much interest banks and thrifts could pay on deposits and was originally constructed for supervisory purposes. During the 1960's and 1970's, Federal Reserve manipulation of those interest rate ceilings, at times, left it open to the charge that it was using Regulation Q for purposes of monetary policy rather than bank supervision policy.

actions may not send a warning, believing that those working in the other jurisdiction will see them quickly. Such an assumption may or may not be warranted. Upon other occasions, attentive staff will try to pass a warning across jurisdictional barriers, but, because we do not have perfect, real-time communication, those who could make most use of the warning may not receive it in time, or have the time, at that moment, to pursue the issue.

There are other costs. Because these companies operate in a highly competitive world of rapidly changing technology, they must be always reshaping their business if they are to survive. As highly regulated institutions, they must seek supervisory approval for nearly every new product or service they wish to offer. In our fractionalized supervisory system, no supervisor has the vantage point from which to see clearly how the proposal might affect important parts of the holding company operation much beyond those parts for which individual supervisors are responsible. Thus, they are poorly positioned to judge how the proposed activity might affect how the parts of the company interact with one another, what kind of supervisory challenges changes in those interactions might pose, and what kinds of supervisory responses they might have to fashion to deal with those interactions. In the absence of an ability to appreciate fully this substantial degree of interconnectedness, there is the very strong possibility that evaluations of critical applications will be second best.

Congressional demands for uniformity, for integration, will not work any better in the area of supervisory tools, such as examination reports, than they did in requiring uniform Call Reports. FIRA required that the FFIEC work toward a uniform report of examination. It has taken us nearly 16 years to come close. On October 1, of last year, the FFIEC announced that the OCC, OTS, FDIC, and the Federal Reserve developed uniform pages that will be used by each agency in its reports of examination. This is not full uniformity, but it is much better than no uniformity at all.

Some Hidden Costs

Multiple supervisors impose other costs. Bank customers lose, sometimes directly, sometimes indirectly. Customers lose directly when they approach Federal supervisors to seek their aid in redressing some banking problem. They must always try to answer the question: To whom should I turn? With our overlapping supervisory structure, that is not a question that they can answer easily.

Customers also lose indirectly. Dollars spent on inconsistent and redundant supervision are passed on, in one way or another, to bank consumers in the form of higher prices. Bank talent used to cope with the current supervisory structure is not available to find and evaluate important lending opportunities in traditional and non-traditional areas; it is not free to stimulate innovation in product development; economic growth suffers.

Managers of banks and thrifts lose as well. Under current arrangements, separate applications for the same transaction must be filed with more than one agency. Recently, I received a letter from a national bank describing the process it faced. The bank, owned by a holding company, filed an application with the OCC to buy a small branch office of an S&L. For the same transaction, the S&L had to file an application with the OTS, and the holding company had to file an application with the Federal Reserve. There was little in common among the three application forms, and they all required a significant amount of work and thus expense above and beyond the usual filing fees. The banker seriously questioned the costs involved, since the assets purchased by the bank were less than one-half of one percent of the assets of the holding company that owned the bank.

THE BENEFITS OF A SINGLE FEDERAL SUPERVISOR

Long delays in the development of important reports and regulations and inconsistencies in supervision are costs that banks should not have to incur and may no longer be able to afford. There is a better way. As you, Mr. Chairman, other congressional leaders, and the Administration have recognized for some time, the essence of reform is simplicity itself—a single Federal supervisor for banks and thrifts.

With a single Federal supervisor—a Federal Banking Commission (FBC)—we will have:

- *Accountability*—There would no longer be any question of which agency the Congress, the public, or depository institutions should address when trying to solve a regulatory or related problem;
- *A More Efficient Decisionmaking Process*—There would be no room for institutional rigidities or competing priorities to interfere with the timely development and implementation of reporting, regulatory, or supervisory policies; and

- *More Consistent Supervision*—Supervisors would focus their attention on banking companies as integrated business units, and there will be no excuse and no tolerance for the inconsistent application of regulations and supervisory policies, as there is today. In case of disputes between bankers and examiners, bankers will have one ombudsman to contact.

Moreover, under the Administration's proposal, we will gain those advantages without compromising the strength or quality of those parts of our supervisory system that we do not need to alter.

PROTECTING SOME BASIC ELEMENTS

Although there is much that is wrong with our supervisory structure and in need of change, there are certain basic elements in our financial system that we must protect. Two of the more important elements are the dual banking system and the strength and independence of both the FDIC and Federal Reserve. The reform proposals we are discussing today will preserve and enhance both.

Protecting the Dual Banking System

Today, Mr. Chairman, when any of us speak about protecting the dual banking system, we are not speaking about preserving dual Federal supervision. We are speaking about protecting the viability of State-chartered banks and thrifts and the viability of State bank and thrift supervision. Surely, we all agree that State-chartered institutions have a long and admirable record of serving our economic system, and that they deserve a supervisory environment that will ensure their capacity to serve. Supervisory reform at the Federal level should preserve and protect State-chartered institutions. The reform we are discussing today will do just that.

Many fear that a single Federal supervisor would weaken State-chartered institutions by acting unilaterally to alter Federal provisions dealing with the powers of State banks. This could not happen under the Administration's proposal. Under this plan, the FDIC would remain the only Federal agency that would have the authority to curtail activities that are permissible for State institutions under State law and only when such activities present unacceptable risks to the deposit insurance funds.

Many believe that a single, Federal supervisor would weaken State-chartered institutions by issuing regulations and implementing supervisory procedures that would favor the banks and thrifts it charters. I do not believe that such a bias, if it ever occurred, could be sustained. Such a bias would occasion strong objections by State authorities and managers of bank holding companies with both State and federally-chartered depositories. At the end of last September, there were 330 such holding companies holding 15.3 percent of all depositories, with 46.3 percent of all depository assets.[5] Neither the FBC nor the Congress could ignore such objections from such a large constituency.

Some opponents of the Administration's plan argue that State-chartered institutions need their own Federal supervisor to protect their interests. They seem, implicitly at least, to believe that this second Federal supervisor would always act in the best interests of State-chartered institutions and the State agencies that supervise them. Will they, at some future date, be so confident as they are today?

Under the single, Federal supervisor envisioned by the Administration, State supervisors would retain the rights and authorities they have today and remain the primary supervisor of the banks that they charter. Moreover, in qualifying States, the FBC will not duplicate examinations of small, well-run institutions conducted by State authorities. Cooperative efforts between the FBC and the States over such issues as sharing on-site examinations and examiner training will go far toward providing States with the tools and incentives they need to be full and innovative partners in bank supervision.

Keeping the FDIC and the Federal Reserve Strong

Some have also feared that a single, Federal supervisor would weaken the FDIC and the Federal Reserve and leave them no room in bank supervision. I disagree. As Secretary Bentsen made very clear yesterday, the FDIC would continue to be the Federal insurer of bank and thrift deposits and the receiver and liquidator of failed depositories. It alone would have the authority to grant and rescind insurance. Moreover, it would retain its "backup" enforcement authority, and it would have full access to all supervisory information at the disposal of the FBC.

The Secretary also made clear his determination to ensure that the Federal Reserve would be able to meet fully all of its central bank responsibilities, including the independent conduct of monetary policy and the management of the payments

[5] Does not include holding companies owning only State-chartered institutions.

system and the discount window. No one questions that the Federal Reserve needs high-quality and up-to-date information about banks and thrifts to meet those responsibilities. In acquiring that information today, the Federal Reserve depends, to a large extent, on other Federal supervisors to supply that information. Moving to a single supervisor from multiple supervisors would not change that process; the Federal Reserve would still have speedy access to all the supervisory information it needs to conduct its core responsibilities. Federal Reserve membership on the FBC board will help ensure that access, as will participation by Federal Reserve examiners in bank examinations, conducted by the FBC, of the largest banking organizations and a cross-section of small, State-chartered banks.

Conclusion

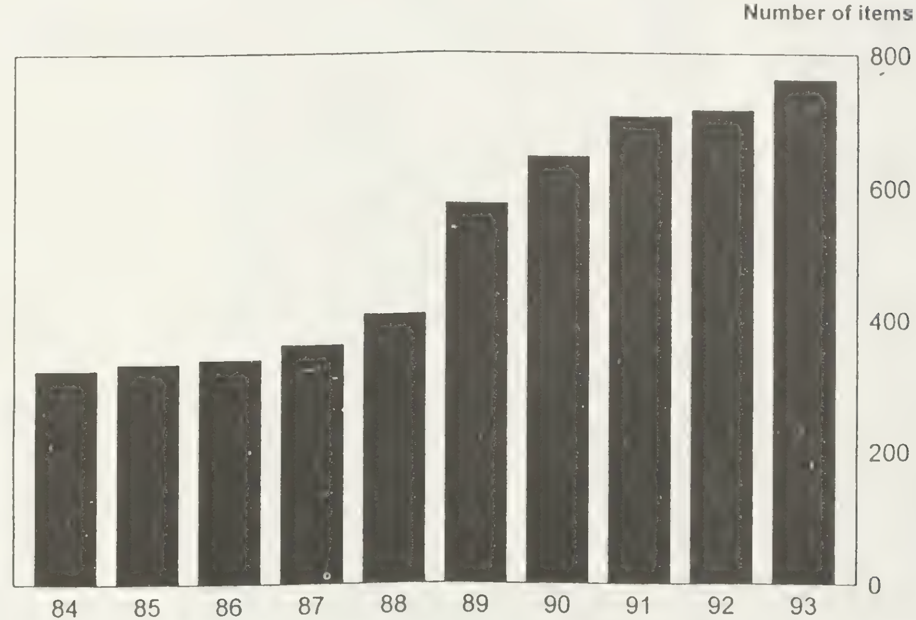
Mr. Chairman, all those who have examined our supervisory structure have found it sadly wanting and in need of substantial repair. The current system failed us repeatedly in the 1980's and the early 1990's. Through FDICIA, Congress addressed some of its weaknesses; however, I strongly believe that patching our supervisory structure is no substitute for rebuilding it, and rebuild it we must. There is every reason to believe that when the next crisis strikes, the costs will again be enormous.

The time to act is now, while the profitability and capitalization of depositories is strong. Over the past 2 years, the performance of banks and thrifts has improved markedly, but over the long term, their survival as low-cost and dynamic competitors is not so clear-cut. Costs imposed upon them by inefficient and redundant supervision—costs they pass on, in some measure, to consumers—together with their long-term decline as major players in financial markets are clouding their future.

To give us a more responsive and more efficient supervisory structure, Mr. Chairman, you, Senator D'Amato, other congressional leaders, and the Administration have all proposed consolidating the supervisory activities of the OCC, OTS, FDIC, and Federal Reserve into a new Federal Banking Commission. This approach to consolidation protects three vital elements of our financial system—the dual banking system, a strong and effective FDIC, and a strong and effective Federal Reserve.

Despite the clear and urgent need for this reform, success will not come easily. Some of those who agree that we need reform, disagree with the reform we have proposed. We need to understand their concerns and ensure that we have done all that we can reasonably do to address them, as we move expeditiously to reform our supervisory system. I stand ready, Mr. Chairman, to help you and the other Members of this Committee in those endeavors.

Call report items for banks under $100 million



Source Federal Deposit Insurance Corporation

Regulatory & Statistical Analysis

Comments on Our Supervisory Structure

Former Members of Congress

1. SENATOR WILLIAM PROXMIRE, former Chairman, Senate Committee on Banking, Housing, and Urban Affairs

"We have the most bizarre and tangled financial regulatory system in the world. It never ceases to amaze me that it has lasted as long as it has.

"Imagine for a moment that we had seven separate and distinct Federal agencies for regulating airline safety. Imagine further the public outcry that would arise following a series of spectacular air crashes while the seven regulators bickered among themselves on who was to blame and what was the best way to prevent future crashes.

"There is no doubt in my mind that the public would demand and get a single regulator. There is a growing consensus among experts that our divided regulatory system is a major part of the problem. There are many reasons for consolidating financial regulations, but most of them boil down to getting better performance."[1]

"[T]he regulatory system is wrong and very wrong. It pits one against the other and it is something that I think we simply have to change." . . .

"There is a clear and direct relationship between the structure of our regulatory system and its performance. Even the best regulators, and they are very good, and the toughest enforcement tools . . . will not do the job under a poorly designed structure."[2]

2. SENATOR ABRAHAM RIBICOFF, former Chairman, Senate Committee on Governmental Affairs

"The structure of commercial banking regulation is unique. In no other situation does a regulated industry have the opportunity to select its Federal regulatory agency. Yet, a commercial bank may choose to be regulated by either the Federal Reserve Board, the Comptroller of the Currency, or the Federal Deposit Insurance Corporation.

"In the Governmental Affairs Committee's study of Federal regulation, we very carefully examined the present structure. We found that when the ability of banks to switch regulators is combined with the fact that the three regulators enforce the same statutes, inconsistent regulation becomes inevitable. Of far greater concern, however, was our conclusion that the three-part structure can undermine the fundamental goals of banking regulation—a safe and sound banking system that encourages competition and innovation."[3]

3. REPRESENTATIVE WILLIAM S. MOORHEAD

"Today I am here to talk to you about chaos in the regulation of financial institutions.

"If you wonder whether or not there is chaos, just suppose you had the duty of explaining to a man from Mars the organization regulation of financial institutions in the United States."[4]

Other Public Officials

4. LLOYD BENTSEN, Secretary of the Treasury

"We can no longer afford the current regulatory structure, a spider's web of overlapping jurisdictions that represents a drag on our economy, a headache for our financial services industry, and a source of friction within our Government."[5]

5. NICHOLAS BRADY, as Secretary of the Treasury

"Our system now has three Federal bank regulators; one thrift regulator; one credit union regulator; and 50 State regulators. Regulations and regulatory respon-

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[1] *Regulatory Consolidation Proposals for Insured Depository Institutions, Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs*, 103rd Cong. 1st Sess. 6 (1993) ("*Regulatory Consolidation Proposals*"), at 8.

[2] *Strengthening the Supervision and Regulation of the Depository Institutions, Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs*, 102nd Cong., 1st Sess., vol. I, 34 (1991) ("*Strengthening Supervision and Regulation*"), at 1005.

[3] *Consolidated Banking Regulation Act of 1978, Joint Hearings on S. 2750 Before the Senate Committees on Governmental Affairs and Banking, Housing, and Urban Affairs*, 95th Cong., 2nd Sess. 1–2 (1978).

[4] *Consolidation of Bank Examining and Supervisory Functions, Hearings Before the Subcommittee on Bank Supervision and Insurance of the House Committee on Banking and Currency and the House Committee on Banking and Currency*, 89th Cong., 1st Sess. 78 (1965) ("*Consolidation of Bank Supervisory Functions*"). *reprinting* "The Tangled Web of Bank Supervision," Address by U.S. Representative William Moorhead to the National Association of Mutual Savings Banks.

[5] Letter to House leaders, November 23, 1993.

sibilities are often overlapping and duplicative. The banking supervisory structures of most of our major competitors are, by contrast, more unified and coherent. As we explore the reform of our financial institutions, we will also need to explore the reform of our regulatory structure—although, to be frank, the inevitable turf fights involved may prevent the full achievement of this goal."[6]

6. RICHARD C. BREEDEN, former Chairman, Securities and Exchange Commission; Co-Chairman, Financial Services Group, Coopers & Lybrand

"Our current bank regulatory system is simply too big, too costly, and too inefficient. At a time when we face extremely difficult and painful choices, as a Nation, regarding resource allocation and Government spending priorities, it is surprising that the bank regulatory system has remained seemingly immune to reductions in overcapacity and elimination or privatization of unnecessary functions. Indeed, the total employment of the depository regulatory agencies in the U.S. is over 40,000 persons. This exceeds the size of several NATO armies, and it is more than 15 *times* greater than the total employment of the SEC, even though the SEC oversees approximately the same number of entities of different types with aggregate assets at least double all the deposits of banks and thrifts in the U.S."[7]

7. DR. ANDREW F. BRIMMER, former Member of the Board of Governors of the Federal Reserve System; President, Brimmer & Company, Inc.

"[U]neven bank examination standards—growing out of our fragmented Federal Bank Regulatory apparatus—contributed to the severe credit crunch of 1990–91 and aggravated the recession which occurred in those years."[8]

8. JEFFREY BUCHER, former Governor, Federal Reserve Board

"As has been stated on previous occasions, developing and implementing appropriate monetary policy at a given time requires consideration and evaluation of an enormous volume of available data.

"The responsibilities are of such magnitude that the Board should not also be burdened with functions not directly related to monetary policy decisionmaking such as the performance of bank supervisory functions and the writings of regulations.

"On the other hand, it is also my view that supervision and regulation of commercial banks is too important a function in itself to be the Federal Reserve's part-time job and the writings of regulations, including those implementing the various consumer protection laws, such as the Fair Credit Billing and Equal Credit Opportunity Acts, justify top priority treatment both in terms of Board time and staff resources.

"It is for these reasons as well that I believe that should any form of restructuring of Federal bank supervision be given serious consideration, it would be unwise to leave these responsibilities with the Federal Reserve.

"Separating the monetary policy matters from the bank supervision and regulation would not, in my opinion, diminish the Federal Reserve's ability to keep abreast of banking developments."[9]

"I can't help but believe that one of the main reasons why many bankers would continue to support the concept of the multiple Federal agencies is this aspect of having the agencies, in effect, court their constituents through changes in or interpretation of regulation, some of which may be to the benefit of the banks."[10]

9. JOHN G. HEIMANN, former Comptroller of the Currency; Merrill Lynch & Company, Inc.

"[T]he system is archaic, it is expensive, it is duplicative, it is inefficient, and I had never thought of the word until Chairman Proxmire used it, it is certainly bizarre."[11]

10. DONALD REGAN, as Secretary of the Treasury

"As financial service organizations offer increasingly similar products and services, the burden on them from the present multiplicity of Federal regulators also increases. In many situations, a single kind of institution or transaction is governed by several Federal agencies, each applying independent and often duplicative or conflicting regulations. For example, three separate agencies regulate and examine commercial banks, five agencies (and the Department of Justice) have some respon-

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[6] *Deposit Insurance Reform and Financial Modernization, Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs*, 101st Cong., 2nd Sess. 775–76 (1990).

[7] *Regulatory Consolidation Proposals*, at 63.

[8] *Regulatory Consolidation Proposals*, at 53.

[9] *Federal Bank Commission Act—1976, Hearings on S. 2298 Before the Senate Committee on Banking, Housing, and Urban Affairs*, 14th Cong., 2nd Sess. 5–6 (1976).

[10] *Id.* at 9.

[11] *Regulatory Consolidation Proposals*, at 17.

sibility regarding mergers or acquisitions involving depository institutions, three agencies provide deposit insurance, and one agency regulates bank holding companies, while different agencies may regulate the subsidiaries of the same firm."[12]

11. J.L. ROBERTSON, former Vice Chairman, Federal Reserve Board

"When you have so many people in so many agencies fighting for their lives, trying to retain the power that they have, it is understandable that it takes a great deal of time before you can get Congress to adopt the legislation. But it will come about eventually.

"The current structure of our Federal bank supervisory mechanism has evolved in a manner both sporadic and haphazard. Needs have been met as they have arisen. Ad hoc solutions have been utilized. Not unexpectedly with such a process, gaps and loopholes in the structure of the law have appeared. Unnecessarily complex, confusing, and even conflicting laws and procedures have all to often resulted in unfairness to both the public and to the banking community."[13]

"The nub of the problem, as I see it, is the simple fact that we are looking for, talking about, and relying upon a system where no system exists. It is not unlike the childhood fable of "The Emperor's New Clothes." Our present arrangement is a happenstance and not a system. In origin, function, and effect, it is an amalgam of coincidence and inadvertence. The notion of a tripartite banking system is an appealing but wholly disingenuous gloss applied to three disparate agencies of completely diverse and independent origin."[14]

"The idea that Federal bank supervision should be unified was brought forward—although not for the first time—just 3 years ago. The idea faced an opposing army then and it does today.

"The most hostile and hard-hitting battalions of that entrenched army consist of those who actually do not want bank supervision to be effective. They fight under a banner bearing the motto "Divide and conquer"—and they have done pretty well along those lines. These people *want Federal* bank supervision to be fragmented; they believe—and there is strong evidence to support their belief—that in such a situation supervisors can be maneuvered into *competing with one another*, and that kind of competition takes the form of a race of laxity that defeats the fundamental purposes that should be served."[15]

12. TIMOTHY RYAN, former Director, Office of Thrift Supervision; Managing Director, J.P. Morgan Securities, Inc.

"There is only one word to describe all of this, and those of you who have ever driven in mid-town Manhattan will know exactly what I am talking about. That word is *gridlock*.

"No one creating a regulatory system today would design such a mechanism.

"This patchwork of supervision was assembled before most of us were born. It is the ultimate consequence of piecemeal legislation."[16]

13. WILLIAM SEIDMAN, former Chairman, FDIC

"Why does it not work now? I think the key reason that it does not work now is that you have three totally independent agencies in the business. There is no power on earth that can make them agree—not the President, not the Pope, not anybody. The only power that can make them agree is the Congress of the United States by changing the structure so that the present setup does not continue."[17]

14. H. JOE SELBY, former Deputy Comptroller of the Currency

"The present regulatory apparatus is outdated and outmoded. Created in response to financial crises and to the introduction of new financial products, it has been rendered inefficient and ineffective in many respects by the rapid changes in the financial system. The present structure of regulation became cumbersome and complex as distinct types of institutions began to offer similar products and services."[18]

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[12] *Financial Services Industry—Oversight, Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs*, 98th Cong., 1st Sess., vol. I, 20 (1983).

[13] *Federal Bank Commission Act of 1977 and Report of the Senate Governmental Affairs Committee on Bank Regulatory Agency Consolidation, Hearings Before the Senate Committee on Banking, Housing, and Urban Affairs*, 95th Cong., 1st Sess. 293 (1977) ("*Federal Bank Commission Act of 1977*").

[14] *Financial Institutions and the Nation's Economy (FINE), Hearings Before the Subcommittee on Financial Institutions Supervision, Regulation, and Insurance of the House Committee on Banking, Currency, and Housing*, 94th Cong., 1st and 2nd Sessions, Part 3, 2290 (1976).

[15] *Consolidation of Bank Supervisory Functions*, at 81–82.

[16] *Regulatory Consolidation Proposals*, at 62.

[17] *Regulatory Consolidation Proposals*, at 15.

[18] *Regulatory Consolidation Proposals*, at 67–68.

PREPARED TESTIMONY OF ANDREW C. HOVE, JR.

ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION, WASHINGTON, DC

Thank you, Mr. Chairman and Members of the Committee. I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation on the proposals to consolidate the financial institution regulators. The subject is an important one that concerns the simplification of the current complex system for overseeing the banking and thrift industries. More broadly, it involves improving the efficiency of Government.

The FDIC favors consolidation of the Federal financial institution regulatory structure. The current system of four regulators—the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision—is not a scheme that a rational individual would design from scratch. The system is a result partly of *ad hoc* responses to particular financial crises that occurred over a period of 150 years. The current and improving health of the industry makes this a good time to simplify the regulatory structure that we have inherited.

In pursuing the goal of regulatory consolidation, however, we must be careful not to destroy the meritorious elements of the current system. After all, the banking industry, under the present regulatory scheme, has been a major contributor to growth in the U.S. economy, an economy that, despite its faults, has been, and remains, one of the most dynamic in the world. Moreover, the banking industry coped with the problems of the 1980's without requiring taxpayers funds. In my testimony, I will focus on what is needed to preserve the effectiveness of a fundamental component of the current system—deposit insurance. I will also say a few words about the desirability of retaining the dual banking system, which at times, in the industry's history, has served as a crucible of financial innovation.

When the details of regulatory consolidation proposals are examined, one striking fact is that the importance of deposit insurance as a component of Government oversight of the financial institutions system is rarely questioned. All of the current major proposals, and all of the realistic proposals of the last several decades that I am familiar with, recognize explicitly or implicitly the central role of deposit insurance. Thus, all proposals call for the continued existence of the FDIC as a deposit insurer. The issue regarding the FDIC becomes one involving essential authorities the agency would need to fulfill effectively its deposit insurance responsibilities under a consolidated regulatory structure. These authorities fall into five main categories: independence, funding, information, enforcement, and resolutions.

Independence

Independence is at the top of the list of what an effective Government deposit insurer should have. The FDIC should not be subject to control by other Executive Branch agencies. And the FDIC should not be subject to the pressures of the election cycle. We have only to recall the experience of the FSLIC to realize the importance of independence for the deposit insurer. As a subsidiary of an agency—the FHLBB—whose mandate included serving as an advocate for the regulated industry, the FSLIC was not independent and was not able to properly address the industry's problems.

The first type of independence—not being subject to control by other agencies—can be accomplished by limiting *ex officio* members to a minority of the FDIC's board of directors. If the FDIC's board consists of five members, no more than two should owe their board membership to other Government positions. For example, if the Chairperson of the proposed Federal Banking Commission and a designee of the Secretary of the Treasury are members of the FDIC's board, the other three members should be appointed to the board by the President and confirmed by the Senate. Among the three Presidential appointees would be the Chairperson and the Vice Chairperson of the FDIC.

Independence from the election cycle—the second type of independence—could be achieved by staggering the terms of the Presidential appointees. Six-year staggered terms would be one option. Of course, the board should be subject to the standard requirement that no more than a bare majority—three out of five members—could be from the same political party.

Funding

A crucial contributor to independence in general is funding freedom, and that leads to the second category of authorities that the FDIC needs to be an effective component of a consolidated regulatory structure. The FDIC should retain its budgetary freedom and continue to determine its own budget consistent with current practices. In addition, the insurer should have the authority to set assessment rates

for each institution, both to maintain the insurance funds and to provide fair and effective risk-related assessments.

Information

The third category of authorities that the FDIC would continue to need if the current system is consolidated concerns information. To be effective, the FDIC would require timely access to sufficient information. The FDIC needs to understand and stay abreast of the changing nature of the risks facing the banking industry; to maintain the necessary expertise in order to analyze and interpret the information provided; and to have an adequate basis to conduct corrective, resolution, and liquidation activities.

Several conclusions flow from the FDIC's information requirements. One is that the Chairperson of the FDIC should be a member of the proposed Federal Banking Commission. This would not only give the FDIC a finger on the information pulse, but also would give the deposit insurer a say—by no means a controlling voice—in overall bank regulatory policy. Giving the FDIC a Commission seat might require a Commission of seven members, but this would help ensure that the agency, like the Federal Reserve Board, has both access to information and input on regulatory and supervisory policy and procedures, including examination policies, procedures, and training. Such input is important to enable the deposit insurer to monitor risks in the banking and thrift system and to the insurance funds.

Another conclusion from an analysis of the FDIC's information requirements is that the agency would need ready access to all reports and records of the Federal Banking Commission and of State authorities relating to depository institutions, their holding companies, and their affiliates, as well as the banking and thrift industries in general. Included in these needed reports and records are all reports of examinations, Reports of Condition, and related correspondence. In addition, the FDIC needs a voice in what information is collected in these reports.

Beyond access to reports and records and input on regulatory policies and procedures, the FDIC would need to retain meaningful backup authority to examine any insured institution to fulfill the insurance function. Backup examination authority enables the FDIC to assess better the risks posed to the insurance funds, to verify information in reports and records, and to obtain additional information for insurance purposes, to monitor troubled and potentially troubled institutions, and to assess the condition of institutions experiencing unexpected changes in circumstances. I believe that these authorities have been exercised in ways that are not duplicative or unduly burdensome to insured institutions. Under any consolidation plan, it must be clearly understood that an effective deposit insurer must be able to exercise an on-site, co-examination role.

Enforcement

The fourth category of authorities the FDIC would need concerns enforcement. Although it would not be a primary regulator, the FDIC would need to retain its enforcement powers. For example, the agency should continue to have the authority to approve or disapprove applications for deposit insurance and to terminate the insured status of an institution if the institution poses a threat to its insurance fund, based on statutory criteria.

Retention of the FDIC's prompt corrective action authority under section 38 of the FDI Act also would be important. This authority includes: (1) the authority to safeguard the insurance funds, (2) the right to prevent a leverage limit of less than 2 percent being set for the definition of "critically undercapitalized," (3) the power to restrict the activities of critically undercapitalized institutions, and (4) the right to withhold concurrence with a determination to defer the appointment of a conservator or receiver for a critically undercapitalized institution. It also includes the authorities given to the FDIC by Congress in FDICIA to appoint itself as conservator or receiver under certain conditions and when necessary to reduce the risk of loss or to reduce the expected loss to the insurance fund.

Resolutions

The final category in the list of what the FDIC would need as an independent insurer under regulatory consolidation is resolutions authority. The FDIC should keep its current authority with respect to failing and failed institutions, to act as receiver or conservator for insured institutions, and to appoint itself receiver or conservator of critically undercapitalized and other institutions. The agency also should retain discretion regarding the purchasers of failed institutions, and the cross-guaranty authority currently in section 5(e) of the FDI Act.

Dual Banking System

Before concluding, I want to say a few words about the dual banking system, and the FDIC's relationship to it.

From the Nation's founding, the States have had a role in bank regulation and supervision. Until the Civil War period, the State role was dominant. From the time of the establishment of the national banking system during that war, the States have divided oversight responsibilities with the Federal Government. The result has been a vibrant, healthy banking system. Significant banking innovations have blossomed under the auspices of State authorities. For example, the growth of checking accounts after the Civil War, the spread of branching in the late 19th and the early 20th Centuries, and the development of NOW (negotiable order of withdrawal) accounts in the 1970's were all the result of initiatives by State-regulated institutions.

Regulatory consolidation achieved at the expense of the innovation-fostering dual banking system would be unfortunate. The FDIC currently exercises a power that bears on the vitality of the dual banking system. The agency rules on the permissibility of activities of State-chartered banks. Given the authority over State powers that Congress gave the FDIC in FDICIA, the FDIC can balance innovation and any risks to the insurance fund. If this authority were transferred to the proposed Federal Banking Commission, all of the authority to determine the powers of banking organizations in a changing world would rest with one Federal Government body, the Commission. The important innovative character of the dual banking system would be compromised. Consequently, leaving the authority to rule on the permissibility of the activities of State banks with the FDIC would seem to be advisable.

Finally, while our testimony does not address other issues regarding personnel, facilities, etc., these matters will obviously need the attention of Congress in the near future. My staff informally has discussed some of these administrative matters with the Office of Management and Budget and the Treasury Department.

Conclusion

To summarize my testimony, the FDIC favors a simplifying consolidation of the bank regulatory system. The current system is not the implementation of a well-thought-out plan but the consequence of *ad hoc* responses to financial crises reaching back to the middle of the 19th Century. Consolidation could eliminate some of the costly redundancies and unnecessary complexities that have developed.

In pursuing the goal of a more efficient regulatory scheme, we should be careful to preserve the good parts of the current structure. One essential feature of the current structure is the independence of the deposit insurer. It is most imperative that we avoid compromising the effectiveness of the deposit insurance program. For 60 years, Federal deposit insurance has been a fundamental component of a largely successful bank oversight structure.

PREPARED TESTIMONY OF JONATHAN L. FIECHTER

ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION, WASHINGTON, DC

Summary

The Office of Thrift Supervision ("OTS") strongly supports consolidation of Federal supervisory responsibility for all banks and thrifts into a single Federal Banking Commission.

Especially at a time when banks and thrifts are steadily losing customers to their less regulated competitors, it is imperative that we find ways to improve our Federal regulatory system.

The objective of the system should be to preserve safety and soundness, while avoiding placing unnecessary burdens on regulated institutions or stifling innovation. I suggest three simple principles, summarized below, for measuring the extent to which our current system, or any proposed alternative, meets this objective.

1. *Efficiency*. There is significant redundancy in many of the tasks now being performed by the four Federal bank and thrift agencies. Not only do the four agencies maintain separate administrative support systems, they also maintain separate regulations, policies, procedures, and expertise in key regulatory areas that need not vary by charter type—such as capital, accounting, transactions with affiliates, lending limits, appraisal standards, and consumer protection. Moreover, under the current system, a single group of affiliated financial institutions can end up being supervised and examined by two, three, or sometimes even four of the Federal bank and thrift regulatory agencies. Consolidation would eliminate these redundancies.

The efficiency of our current regulatory system is also substantially hindered by regulatory gridlock. In an effort to maintain some level of consistency, the four agencies consult extensively before most major regulatory initiatives. The result is that significant regulatory safety and soundness initiatives have taken years to emerge from this interagency process. Unfortunately, long and tedious negotiations are the rule, rather than the exception, in this process. Neither institutions nor taxpayers can afford to wait for years when regulatory changes are needed to respond to market innovations or to threats to safety and soundness.

The efficiency of our current regulatory system is also adversely affected by the loopholes and inconsistencies that inevitably arise when there are four separate Federal regulators. Notwithstanding efforts at interagency coordination, numerous differences still exist in the regulatory approaches of the four agencies. This affects the ability of banks and thrifts to compete on a level playing field. For example, the regulatory costs of Federal supervision are unevenly spread among banks and thrifts. In addition, attention has recently been focused on the fact that OTS-supervised thrifts converting from mutual to stock form often face more stringent rules than thrifts not supervised by OTS.

We need to eliminate the inconsistency, gridlock, and redundancy that are the inevitable byproducts of a system with four separate Federal regulators. Consolidation will do this.

2. *Effectiveness.* It is impossible to have an effective regulatory system unless the agencies administering the system have adequate funding and are able to recruit and retain well-trained professionals. If the current regulatory system is left in place, the OTS may become vulnerable on this point.

Since the OTS was established in 1989, thrift industry assets have declined by 37 percent. In recent years, most of this decline has been due to voluntary conversions and mergers and acquisitions resulting in charter changes. OTS has responded to this phenomenon by reducing its staff by 44 percent over the past 4½ years. Additional reductions will be required since shrinkage of the thrift industry continues. Unless something changes, OTS faces a prolonged period of indefinite, continuous downsizing.

Companies or agencies faced with indefinite downsizing must either consolidate or go out of business. Surviving as a stand-alone organization, under such circumstances, becomes virtually impossible because the best people in the organization eventually give up hope and leave, creating significant quality control problems. We cannot afford a repeat of the mid-1980's scenario of a weak, understaffed thrift supervisory effort.

Consolidation of the four Federal bank and thrift agencies would resolve this potential quality-control problem because, among other things, the consolidated agency would continue to regulate converting institutions regardless of what form their charter takes.

3. *Separation of Regulatory Functions.* One of the most important lessons learned from the thrift crisis is that the same regulatory agency should not serve both as safety and soundness regulator and deposit insurer. As the experience of the former Federal Home Loan Bank Board ("Bank Board") demonstrates, the responsibilities of safety and soundness supervision and deposit insurance may at times be in conflict. The Bank Board allowed concern about depletion of the insurance fund to cause it to become a lenient safety and soundness regulator. The opposite problem can also arise—an agency may place so much emphasis on protecting the insurance fund that it becomes unduly rigid in responding to industry innovations.

The proposed consolidation would result in clear separation of safety and soundness and insurance responsibilities. The Federal Deposit Insurance Corporation ("FDIC") will continue to insure the deposits of banks and thrifts. The new agency will have no insurance function. In addition, primary supervisory responsibility for State nonmember banks will be transferred from the FDIC to the new agency, putting an end to the FDIC's Bank Board-like dual role of insurer and regulator. This will ensure a healthy distribution of regulatory responsibilities between the Commission, as pure safety and soundness regulator, and the FDIC, as pure insurer.

Introduction

Mr. Chairman and Members of the Committee, I appreciate this opportunity to present the views of the Office of Thrift Supervision ("OTS") on the Administration's proposal to consolidate Federal supervision of all banks and thrifts insured by the Federal Deposit Insurance Corporation ("FDIC") into a single agency.

The Federal Government has an obligation to ensure that its regulation of banks and thrifts is efficient, effective, and flexible and that it adapts to changing conditions. Our country has been well-served by our depository system of banks and thrifts. They form one of the cornerstones of our economy.

In recent years, however, nonbank providers of financial services have entered many of the traditional lending areas that were once served primarily by banks and thrifts. The result has been that banks and thrifts have steadily lost customers to other types of financial companies such as mortgage companies, Government-sponsored financial intermediaries, securities firms, investment companies, and the financial affiliates of major corporations. These companies are typically subject to much less extensive Government regulation than banks and thrifts.

There have been similar trends in deposits. While the total combined deposits of banks and thrifts have experienced no net growth since 1989, the total assets of mutual funds and money market funds have shot up by 92 percent from $994 billion to $1.9 trillion as of the end of the third quarter of 1993. This compares to total bank and thrift deposits of $3.4 trillion.

At a time when slight differences in operating expenses can make the difference between success and failure, some analysts have begun to question whether banks and thrifts can effectively compete with their less regulated counterparts.

For this reason, among many others, it is imperative that we find ways to improve our Federal regulatory system for banks and thrifts.

The objective of our regulatory system should be to preserve safety and soundness, while avoiding placing unnecessary burdens on regulated institutions or stifling innovation. I suggest three simple principles for measuring the extent to which our current system, or any proposed alternative, meets this objective:

1. *Efficiency.* Does the regulatory system avoid overlap and duplication? Does it allow for early identification and rapid response to problems? Is the system flexible and open to innovation? Can regulated institutions receive prompt consideration of proposed changes in their business strategies?
2. *Effectiveness.* Does the regulatory system have adequate resources? Is it able to attract and retain competent supervisory staff?
3. *Separation of Core Functions.* Is regulatory responsibility allocated in a manner that avoids systemic conflicts that may compromise safety and soundness or other regulatory objectives?

Our current bank regulatory system does not fare well under these three criteria, especially the first—efficiency. A regulatory system that is inefficient will drive up the cost of doing business for regulated institutions, will be slow to authorize new products and services for consumers, and will fail to respond quickly to threats to safety and soundness or to consumers. For these reasons, an inefficient system will ultimately weaken the industry it regulates and fail to preserve safety and soundness.

Those who are not involved in bank and thrift regulation on a daily basis may not realize the full extent of the inefficiency in our current regulatory system. In my testimony today, I will provide concrete examples.

I will also explain why I believe our current system is vulnerable in the other two areas I have highlighted—effectiveness and separation of core regulatory functions.

The Administration has responded to the problems of our current system by proposing to consolidate Federal supervisory responsibility for all FDIC-insured banks and thrifts into a single Federal Banking Commission. Similar proposals have been made by the Chairman of this Committee and its Ranking Minority Member, and by the Chairman of the House Committee on Banking, Finance and Urban Affairs and twelve other Members of that Committee. Another proposal that would result in consolidation of the OTS and the Office of the Comptroller of the Currency ("OCC"), and some realignment of supervisory jurisdiction among the Federal banking agencies, has been made by the Ranking Minority Member of the House Committee on Banking.

I strongly support consolidation of Federal supervisory responsibility for all FDIC-insured banks and thrifts into a single Federal Banking Commission. Consolidation will make our regulatory system much more efficient and effective, while ensuring proper separation of core regulatory functions.

I. Efficiency

The first of the three key standards I have suggested for evaluating the current bank regulatory system, and any new system, is efficiency. Our current system is inefficient for at least three reasons.

A. *Needless Duplication and Inconsistencies*

There is substantial overlap in many of the functions currently performed by the four Federal bank and thrift regulatory agencies. Each of the agencies has its own unique, yet redundant, personnel and administrative support systems, contract and procurement processes, accounting and records systems, and regional offices. After

a transition period, savings could be achieved from the economies of scale that would result from combining these duplicative functions.

Beyond this, however, I believe that significant efficiencies could also be achieved by further standardizing safety and soundness and consumer compliance regulation. I am speaking not only of the text of the rules, but also implementation of the rules. This type of standardization could be achieved without compromising the integrity of the different forms of depository institution charters. The core of various regulatory fundamentals—such as capital, accounting, transactions with affiliates, lending limits, appraisal standards, and appropriate disclosure—need not vary by institution type, even though other charter-specific rules are required to reflect charter distinctions. Indeed, in recent years, Congress has mandated that the four Federal bank and thrift agencies standardize their rules in many of these areas, and the agencies now voluntarily try to coordinate decisionmaking in all key policy areas.

Nevertheless, under the current system, each agency still typically develops its own implementing policies and procedures, trains its examiners separately, and maintains its own set of specialists in each regulatory area. The result is frequent duplication of effort and inconsistency among the agencies in their implementation of the rules.

However, problems with duplication and waste do not stop here. Even if the four agencies were able to achieve perfect harmony in their regulatory and supervisory approaches, institutions would still be forced to be examined by and answer to multiple regulators. Under the current system, it is possible—and quite common—for a single group of affiliated financial institutions to be regulated by more than one—and sometimes all—of the Federal bank and thrift regulators. For example, a group of companies that includes a holding company with a national bank subsidiary, a State nonmember bank subsidiary, and a thrift subsidiary will be examined and regulated by all four Federal bank and thrift regulators. In this type of corporate structure, the Federal Reserve Board and the OTS share responsibility for examining and supervising the holding company; the OCC examines and supervises the national bank; the FDIC examines and supervises the State nonmember bank; and the OTS examines and supervises the thrift. Almost half of all bank and thrift assets are held by organizations that are now regulated by three or four of the Federal bank and thrift agencies.

This multiple-regulator approach not only places tremendous demands on the resources of the agencies and institutions involved, but also makes it cumbersome for any one regulator to get a complete picture of the safety and soundness of the entire corporate structure.

The proposed consolidation of the supervisory jurisdiction of the four Federal bank and thrift agencies would put an end to this awkward and wasteful system of regulation.

B. *Regulatory Gridlock*

Under the current bank and thrift regulatory system, most significant regulatory initiatives involve interagency consultation. Building consensus frequently takes months, sometimes even years—and, in the process, consumes significant staff resources. Although interagency committees act in good faith, inevitably a certain amount of bureaucracy, rivalry, and turf consciousness creeps into the process. There is a natural tendency for each agency to think it has the better idea. With the decisionmaking process split among the four agencies, there is a loss of accountability. New initiatives and innovations often get bogged down in endless interagency debates.

Let me offer some examples. In the summer of 1989, the four bank and thrift agencies formed a working group to develop common rules to govern the capital treatment of recourse obligations. These are the obligations that institutions incur when they sell loans or other assets subject to an agreement to repurchase or replace the assets if they go into default. This was an important safety and soundness initiative because banks and thrifts regularly engage in billions of dollars of recourse transactions. Under existing capital rules, various forms of recourse transactions that present the same level of economic risk get very different capital treatment. In theory, therefore, institutions are either being required to reserve far too much or far too little capital in connection with their recourse transactions. Notwithstanding the importance of this issue, the interagency working group took a full year to agree on the wording of an Advance Notice of Proposed Rulemaking that merely announced the issues under consideration and requested public comment. Thereafter, it took another 3½ years, until December of 1993, for the interagency group to reach agreement on a proposed regulation. Thus, almost 5 years have passed and the agencies are still at the proposal stage. No final rulemaking is anywhere in sight.

Another example of the regulatory gridlock that results from the current four-agency system is in the area of allowances for loan losses. In December of 1990, the four agencies formed a working group to prepare more detailed guidance for examiners and institutions in determining loan loss allowances. This, too, is an area of critical regulatory importance since examiners and institutions frequently disagree about loan loss allowances and such allowances have a direct impact on an institution's bottom line. It nevertheless took until December of 1993, 3 full years, to reach agreement on an interagency policy statement on loan loss allowances. What is even more frustrating is that the last 12 months of interagency meetings resulted in very few substantive changes to the policy statement.

The problem with this interagency process is not the people who have staffed the interagency committees. These people have worked extremely hard and long hours to reach consensus. The problem is with the cumbersomeness of the process.

This is no way to regulate a financial system where there are frequent changes that require rapid responses. When changes are needed to respond to market innovations or to threats to safety and soundness, neither institutions nor taxpayers can afford to wait for months or years. Especially when safety and soundness issues are at stake, we should not tolerate a system that takes years to react.

Creation of a single Federal safety and soundness regulator will put an end to this cumbersome, resource-intensive process of interagency policymaking.

C. *Level Playing Field*

The third problem with the efficiency of the current system is the differences and the inequities that arise when there are multiple Federal regulators. The costs associated with inconsistencies in the operations of the individual agencies far outweigh any marginal benefits that may result from allowing institutions to choose their Federal regulator.

For instance, during much of the 1980's, thrift institutions were allowed to operate at capital levels below that of their bank competitors. While this provided poorly capitalized thrifts with a competitive advantage over weak banks, the ultimate costs were huge. More recently, the public has focused on the fact that OTS-supervised thrifts converting from mutual to stock form often face more stringent rules than converting thrifts that are not supervised by OTS.

Sometimes the differences are more subtle. Statutes and their implementing rules are sometimes interpreted more conservatively by one agency than another. Differences also arise solely due to timing, as is illustrated by implementation of an interest rate risk model for thrifts but not for banks.

Some differences result directly in higher regulatory costs. The fact that institutions examined by the OTS and OCC are assessed for the cost of supervision while State-chartered banks are not assessed for their Federal supervision places economic pressure on institutions to change their charters. The cost to institutions of such differences affects their ability to compete.

The existence of four different Federal regulators with four different experiences, approaches, and perspectives inevitably creates openings that some institutions will rush to exploit.

I believe in the importance of flexibility and innovation in Federal bank and thrift regulation. We do not want backward-looking agencies that stifle legitimate corporate transactions or innovations. But the notion that competing Federal regulators are necessary to ensure adequate flexibility and innovation is not credible. This notion is completely foreign to any area of Federal regulation other than banking. This notion is also inconsistent with the major banking statutes enacted by Congress in recent years, which have required increased standardization in safety and soundness and consumer regulation.

I do not mean to suggest, however, that consolidation of the Federal bank and thrift agencies will mean that all banks and thrifts must be regulated exactly the same, even at the Federal level. Thrifts feel just as strongly as State banks about the importance of being regulated by persons who understand and respect their specialized operations. It is not necessary to eliminate distinctions among national banks, Federal thrifts, State thrifts, State member banks, and State nonmember banks. In fact, taking a "one size fits all" approach to regulation fails to recognize the legitimate charter differences that currently exist among institutions. What we need is to eliminate the loopholes, pointless differences, and waste that are the inevitable product of a Federal system with separate agencies with distinct regulatory agendas. This is what the Administration's consolidation proposal would accomplish.

II. EFFECTIVENESS

The second of the three criteria that I have suggested for measuring the performance of our current Federal bank and thrift regulatory system and any new system

is effectiveness. It is not possible to have an effective regulatory system unless the agencies administering the system have adequate funding and are able to recruit and retain well-trained staffs.

I am concerned that if the present regulatory system is left in place, the OTS may become vulnerable to failing the effectiveness test. The number of OTS-supervised thrifts has been rapidly dwindling since passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"). Ironically, this comes at a time when the thrift industry has recovered from the financial trauma of the 1980's. During the third quarter of 1993, 95 percent of all OTS-supervised private-sector thrifts were profitable and 99 percent of these thrifts met or exceeded their statutory capital requirements.

The OTS, which is not quite 5 years old, has worked closely with the Federal banking agencies to develop sound regulatory policies for thrift institutions that are consistent with those applied to commercial banks. The recovery of the thrift industry is due in part to the aggressive supervisory and enforcement activities of OTS both in weeding out nonviable thrifts from the industry and working closely with weak but viable thrifts to facilitate their recapitalization.

Despite its financial recovery, however, the thrift industry continues to shrink rapidly. Since enactment of FIRREA, thrift industry assets have declined steadily from $1.3 trillion to $821 billion as of the end of the third quarter of 1993. During the first few years after FIRREA, most of this shrinkage was due to resolutions of insolvent thrifts. More recently, the shrinkage is largely due to voluntary conversions and acquisitions and mergers that result in charter changes.

There are six principal reasons why institutions have been voluntarily changing charters:

- *The Impending SAIF/BIF Premium Differential*—Bank Insurance Fund ("BIF") premiums could decrease substantially in the near future, whereas Savings Association Insurance Fund ("SAIF") premiums are likely to remain at or near their current level or even increase—primarily because over 40 percent of all SAIF premiums are being diverted to pay interest on the long-term bonds issued by the Financing Corporation;[1]
- *Mandatory Federal Home Loan Bank ("FHLBank") Membership*—OTS-supervised thrift institutions alone, among the various types of depository institutions, are required by statute to be FHLBank members;
- *Examination Fees*—Unlike OCC and OTS, neither the FDIC nor the Federal Reserve Board charge institutions under their supervision for examination and supervisory activities;
- *Differences in Regulatory Scrutiny*—Some OTS-supervised thrifts converting to State savings bank charters appear to believe they will gain a more advantageous regulatory environment;
- *Differences in Statutory Powers*—Some thrifts are converting to national or State bank charters in order to utilize the broader range of lending and other powers available to banks;
- *Industry Consolidation*—Some thrifts are giving up their charters in acquisitions and mergers with banks as part of the general trend toward industry consolidation.

Some of these reasons for thrift charter conversions are market driven. Others raise significant public policy questions that may call for a legislative response. I am not here to argue that Congress should halt the decline in OTS-supervised thrifts. Rather, my immediate concern is whether OTS can continue to do its job if the thrift industry continues to shrink in the future as rapidly as it has over the last several years.

Shrinkage in the industry affects OTS's assessment income and the number of staff needed to fulfill our regulatory mandate. At first blush, this would seem to present no problem—the simple solution is to reduce staff and expenditures as the industry shrinks, and increase assessments when necessary. To date, the OTS has worked hard to limit assessment increases,[2] and instead has acted aggressively to reduce expenditures and staff.

Shortly after FIRREA was passed, the OTS had 3,389 employees. Today we have only 1,896. This represents a decrease of 44 percent, which has been accomplished through a combination of attrition, early outs, and multiple reductions in force

[1] Prior to extension of the statutory SAIF exit moratorium late last year, many thrifts were converting to bank charters to position themselves to leave the SAIF quickly when the moratorium expired. Although thrifts can no longer hope to escape the SAIF via charter conversions, the impending premium differential is still likely to cause industry shrinkage as institutions downsize or go out of business due to competitive disadvantage.

[2] The OTS is currently considering adjusting its assessment system to increase OTS revenue.

("RIF's"). Our staff cuts over the last 4 years have averaged over 12 percent per year.

Even after 4 years of downsizing, however, there is no end in sight. The loss of jobs has been—and will continue to be—painful for those who are most directly affected by our downsizing. But we have faced our problems squarely and have continued to shrink with the industry. I am proud of the excellent job that OTS staff has done despite all the uncertainty.

What concerns me about downsizing is not the decline in the raw number of employees at OTS. I would not argue that there is some specific number of employees below which OTS cannot properly do its job. There are Government agencies that function well with considerably less staff than the OTS still has. Our problem is not size, as such.

Rather, the problem lies in the dynamics of an agency that is in an indefinite, continuous downsizing spiral. It is not uncommon for corporations and Government agencies to experience several years of significant downsizing. In these situations employees know that if they can hang on for a few years, their company or agency will stabilize and the threat of layoffs will subside. But that is not our situation. We must assume that it is possible that we will face continuous downsizing.

Companies or agencies faced with indefinite decline must either consolidate or go out of business. Surviving as a stand-alone organization under such circumstances becomes virtually impossible because the best people in the organization eventually give up hope and leave. As a result, an organization facing long-term decline will have trouble maintaining its performance quality.

Let me offer a practical example. Earlier in my testimony, I alluded to the fact that the OTS recently promulgated rules implementing Congress' mandate to regulate interest rate risk. This represents a significant advance in safety and soundness regulation. However, our ability to follow through and effectively supervise this new program could be in jeopardy. Over the past 24 months, the OTS has lost several of its key interest rate risk experts. To date, our efforts to hire qualified replacements have been unsuccessful; candidates have expressed concern regarding the future of the agency. If we lose one or two more people in this highly specialized area, we may not have the necessary expertise to implement our interest rate risk program effectively.

This is just one example that could be repeated in a number of areas. Successful supervision of sophisticated financial institutions requires a core of highly skilled staff. But staff with these kinds of highly marketable skills are understandably reluctant to stay at, or accept a new position with, an agency that can offer them no assurance, even in the short term, that they will continue to have jobs.

This is our problem. If the thrift industry continues to shrink at its present rate, the OTS could reach a point when the quality of its staff will deteriorate below an acceptable level. We cannot afford a repeat of the mid-1980's scenario of a weak, understaffed thrift supervisory effort.

A consolidation of the supervisory resources of the four Federal bank and thrift agencies into a single Federal Banking Commission would solve the problem of instability at the OTS for at least two reasons. First, the number of charter conversions would likely moderate, since at least some of these conversions are motivated by a desire to exploit regulatory differences among the four Federal agencies. Second, charter conversions that continue to take place would require a simple realignment of resources within the new agency, since the new agency would continue to regulate the converting institution regardless of the form the charter takes. Unfortunately, a simple merger of the OTS and the OCC would not produce the same benefits since conversions to State bank charters would still impact the resources of a combined OTS and OCC and some institutions would still be motivated to convert to exploit Federal regulatory differences.

III. Separation of Regulatory Functions

The third and final criterion I have suggested for measuring the effectiveness of our current bank regulatory system and any new system is whether potentially conflicting regulatory functions are assigned to different agencies.

One of the most important lessons we learned from the thrift crisis is that responsibility for both safety and soundness regulation and deposit insurance should not be assigned to the same agency. As you know, the former Federal Home Loan Bank Board ("Bank Board") served both as primary regulator of thrifts and as the governing board of the Federal Savings and Loan Insurance Corporation ("FSLIC"), which insured thrift deposits. This structure created profound safety and soundness problems.

During much of the 1980's, the FSLIC was short on funds. The FSLIC's precarious financial condition motivated the Bank Board to try to postpone resolution of

insolvent institutions via regulatory gimmickry and, when resolutions were unavoidable, to engage in restructuring transactions that would impose minimal short-term costs on the FSLIC. During this period, new activities were authorized for thrifts, capital and accounting standards were liberalized, rapid growth was permitted, and forbearances and tax breaks were offered as transaction incentives.

Because the Bank Board was the only Federal agency with responsibility for the regulation of thrifts, there was no backstop—no strong, alternative voice questioned the Bank Board's actions. The Bank Board could—and did—subordinate safety and soundness regulation and long-term costs to taxpayers to a crisis-response strategy that reflected the weakness of the insurance fund.

The opposite problem is also possible when safety and soundness and insurance regulation are combined in the same agency. Instead of subordinating safety and soundness to insurance concerns, an agency with responsibility for both might allow its concern for the insurance fund to cause it to be unduly rigid in responding to industry innovations.

The Administration's proposed bank and thrift agency consolidation avoids these pitfalls. The new Federal Banking Commission will have no insurance function. The FDIC will continue to insure both banks and thrifts. In addition, primary supervisory responsibility for State nonmember banks will be transferred from the FDIC to the Commission, putting an end to the FDIC's Bank Board-like dual role of insurer and regulator.

As insurer, the FDIC will continue to possess strong regulatory powers that will enable it to challenge any Commission actions that could present undue risk to the insurance funds. The FDIC's powers will continue to include "back up" authority to take enforcement action if the Commission fails to do so, and the ability to evaluate risk independently of the Commission through the process of setting risk-based insurance premiums. I believe the FDIC's role is an important one. Although there were some initial bumps in the road when the FDIC and the OTS began working together 4½ years ago, over time the two agencies have settled into a good, productive working relationship. I believe that the "backup" oversight role being played by the FDIC is an important part of our Federal regulatory structure.

Under the proposed agency consolidation, the FDIC will continue to play this role, while ceasing to serve as primary Federal regulator of State nonmember banks. This will ensure a healthy distribution of regulatory responsibility between the Commission, as pure safety and soundness supervisor, and the FDIC, as pure insurer.

Conclusion

In summary, I support the Administration's proposal to consolidate the supervisory responsibilities of the four Federal bank and thrift regulatory agencies for at least three reasons:

First, the proposed consolidation will eliminate a tremendous amount of waste by allowing common administrative and regulatory functions to be consolidated, by putting an end to interagency regulatory gridlock, and eliminating pointless differences in Federal regulation of banks and thrifts.

Second, the proposed consolidation will end the threat to the effectiveness of the OTS as primary Federal thrift regulator.

Third, the proposed consolidation will enhance safety and soundness by establishing a pure safety and soundness regulator and a strong, autonomous insurance regulator.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM ALAN GREENSPAN

Q.1.A. In your testimony you repeatedly emphasized the need for maintaining "competition" among bank regulators. For example, you said that a "single regulator would deprive our present regulatory structure of what the Board considers to be an invaluable restraint on any one regulator conducting inflexible, excessively rigid policies." You also said that a single regulator—even if that regulator were the Fed—would be "prone to arbitrary and capricious behavior." Given your position I have several questions: If regulatory competition of this kind is so necessary, why should the Fed retain full regulatory and supervisory control of all large bank holding companies as your proposal provides?

A.1.A. My testimony did not call for regulatory "competition," but did argue that "choice" among regulators would be, as your question notes, ". . . an invaluable restraint on any one regulator conducting inflexible, excessively rigid policies." "Choice" would not, as the position paper attached to my statement indicates, lead to "competition in laxity" for reasons noted there—including FDICIA and similar statutory establishment of minimum standards.

The position paper also indicated the reasons for proposing that certain large bank holding companies come under the purview of the Federal Reserve, and, hence, have no regulatory choice. In order to manage financial crises and accomplish the central bank objective of constraining systemic risk, the Federal Reserve needs to have not only direct hands-on knowledge of banking operations at the largest institutions, but also have the clout and authority to affect events. Report reading and advisory status would not act as a substitute. In essence, the proposed lack of choice of holding company regulator by certain banking organizations reflects a trade-off among competing goals—in this case, a trade-off between choice of regulator and regulatory efficiency, on the one hand, and the imperatives of macrofinancial stability, on the other hand.

Q.1.B. You stated in your testimony that the Fed must retain jurisdiction over "a modest number of banking organizations that met certain criteria—such as large size and payment and foreign activity. . . ." Could you be more specific as to the standards that you would use to determine whether an institution would fall into this class? Could you please justify these standards with respect to the Fed's monetary policy responsibilities and conduct of its other functions?

A.1.B. We have proposed that the bank holding companies of banking organizations that meet any *one* of the following criteria be under the Federal Reserve's jurisdiction:

(a) The sum of the assets of all insured commercial bank subsidiaries in each organization equal or exceed one-half percent of aggregate worldwide consolidated bank assets of all U.S. insured commercial banks;

(b) Commitments to purchase foreign currency and U.S. dollar exchange (spot, futures, forwards), written and purchased foreign exchange options, and foreign currency swaps must be at least $5 billion;

(c) Daily average total—funds and securities—originations over Fedwire and/or CHIPS must be at least $5 billion.

The organizations selected by the criteria are engaged in the kinds of financial operations that play a significant role in the world financial markets. Difficulties at one of them could thus cause significant disruption in the world financial markets, not only creating systemic risk but requiring central bank cooperation. In addition, these organizations are engaged in the most innovative financial transactions at the frontier of financial technology. The central bank's supervision of these holding companies thus provides valuable insight and knowledge required to manage future financial crises and to monitor changing effects of monetary policy on financial markets, and, hence, on the real economy.

Q.1.C. You stated in your testimony that, as a result of its authority over bank holding companies, the Fed supervises and regulates, on a consolidated basis, "more than 90 percent of the total banking assets in the system." Can a supervisory structure that concentrates that much authority in a single regulator promote the type of competition you believe is necessary? Exactly how much control over the banking system does the Fed need to carry out its crucial responsibilities and how much competition among regulators is necessary to avoid the evils you have referred to?

A.1.C. I did not say that the Fed supervised and regulated more than 90 percent of total banking assets. According to the transcript, I said, ". . . we supervise and regulate all the *holding companies* which have, on a consolidated basis, more than 90 percent of the total banking assets in the system" (italics added). Those holding companies are important because through them we obtain both insight into how the subsidiary banks—most of which are now regulated by the FDIC or OCC—operate and how policies are made and, significantly, the ability to influence events when necessary. We now supervise *directly* less than 9 percent of the banks having less than 20 percent of insured commercial banking assets. Thus, the Fed now does not have the kind of regulatory "concentration" the question implies.

My answer to Senator Bennett's question on March 3, in which I mentioned the 90 percent figure, went on to say, "The issue of the number of banks we examine . . . is a wholly different question from the bank holding company supervision and regulation and especially rulemaking question." I indicated then that we need only a sample of banks—of various sizes—large enough to provide us with an information and knowledge base to understand banking developments and feedbacks for monetary policy purposes. I said that, "We don't need to have a major extension of presence in the number of banks or the proportion of assets which we currently examine."

In the attachment to my prepared statement, I indicated the proposal to include State *nonmember* banks under the Fed ". . . results solely from the view that in a two agency structure it is desirable that there should be a clear delineation of supervision and regulation responsibility by charter class in order to preserve the dual banking system. The Board makes no case that responsibility for

such banks . . . is needed for financial stability and monetary policy purposes."

In sum, to carry out its critical responsibilities, I believe the Fed needs to supervise and regulate: (1) holding companies of those large banking organizations that meet specific criteria that establish their significance for financial market stability; and (2) a sample of banks of various size and location—about the same as the current State member bank panel. I do not call for "competition" in regulation but I do propose: (1) "choice" that permits banks to select one of two Federal regulators by selection of charter of the lead bank; and (2) except for a small handful of large national bank organizations, one supervisor per organization based on the charter class of the lead bank.

Q.1.D. If competition is essential, would it not be better to have multiple regulators responsible for writing the rules that implement consumer protection statutes such as the Truth-in-Lending and Truth-in-Savings Acts, rather than giving the Fed exclusive rulemaking authority?

A.1.D. No, for the following reason. Policies that govern how banks are regulated and supervised for safety and soundness reasons are distinct from policies implementing consumer protection laws. The primary focus of consumer protection statutes is to ensure consumers can compare credit (or deposit account) features for all financial institutions (and all creditors) by providing uniform cost information for comparison shopping. For example, in the Truth-in-Lending Act, the "finance charge" measures the dollar amount of the cost of credit, and the "annual percentage rate" (APR) expresses the cost as a percentage. It is critical that a single entity define these and other disclosed terms for all financial institutions (or creditors). If multiple regulators permitted terms such as the APR to be calculated differently, the point of the legislation would be lost.

Q.2. In your written statement you extolled the virtue of having a system that "provides banks with a method of shifting their regulator" in order to avoid an excessively rigid regulator. Please explain what limits you would place on such a system to avoid safety and soundness concerns?

A.2. The system should have two types of limits. First, switches in the appropriate Federal banking agency should not result from temporary changes in the balance sheets or operations of institutions or from inadvertent changes or inappropriate manipulations. This can be addressed by permitting shifts based on calculations of averages of well-defined terms, such as Call Report information, reported over a sufficiently long period of time. For example, the size of the lead banking institution for a holding company could be based on a comparison of the average total assets reported by the institution over an eight quarter period. The proposal could also provide that changes may only occur at certain intervals (for example, once each year) or after changes that generally require agency approval (such as changes in charter).

Second, the agencies should be granted authority to delay or prevent a shift in regulators if the agencies determine that the shift is not consistent with the effective supervision of the institution or with other safety and soundness concerns. Similarly, if shifts are

permitted only at certain intervals, the agencies should be permitted to accelerate the timing of a shift in agencies where the agencies determine the shift is appropriate and is expected to occur at the conclusion of the interval.

Q.3.A. In December 1993, you stated in an op-ed article in the Wall Street Journal that "[i]t is unrealistic and unduly hopeful to believe that the knowledge and expertise that the Federal Reserve needs to do its job properly can be gained from studying the exam reports of another agency. . . ." But is this not exactly what the Federal Reserve does? Your examiners do not go in and inspect national banks, or State nonmember banks, or thrifts, repeating the work of the other agencies, do they? What exactly do Fed examiners do when they inspect bank holding companies where the Fed is not the primary regulator of the holding companies' subsidiary banks?

A.3.A. As the question in the above paragraph suggests, the Federal Reserve, in conducting inspections of bank holding companies owning national banks, State nonmember banks, or thrifts, except in unusual circumstances, relies on a review of the examination reports of the agencies that are the primary supervisor of the banks as part of the process of developing an assessment of the overall condition of the holding company. It is important to recognize, however, that we are able to understand and effectively interpret the examination reports of other agencies because we have a field staff and a policy development and enforcement staff that have long and broad experience in examining and supervising banking organizations. This experience has been gained from carrying out the Federal Reserve's assigned responsibilities as the primary supervisor of State member banks, all bank holding companies, Edge Act Corporations, and foreign banks. The hands-on supervisory experience which the Federal Reserve obtains in carrying out its primary supervisory responsibilities not only enables it to effectively evaluate the reports of the other supervisors, it also provides an invaluable source of information and understanding for the Board and Open Market Committee of the activities, practices, and attitudes of, and innovation in, a critically important sector of the financial system—one that serves as a principal source of credit for businesses and households, the means by which payments are effected in the domestic and world economy, and a main conduit for the transmission of monetary policy actions.

Q.3.B. Has the Federal Reserve's reliance on examination reports compromised its ability to conduct monetary policy?

A.3.B. The Federal Reserve has never said that it must examine every banking organization in order to gain the knowledge just described. What we have said is that the Federal Reserve needs to be involved in supervising a sufficient number of banking companies of various sizes and locations to enable us to obtain a knowledge of the practices of, and interrelationships within, the banking system and financial system, both domestically and internationally. Moreover, to be able to remain informed about financial innovation, foreign activities, and payments, as well as have the authority to affect events, the Federal Reserve needs to be involved in the supervision of large, internationally active, significant banking organizations.

Q.4.A. The Federal Reserve has the authority to charge bank holding companies for its examination and inspection expenses but chooses not to. Ultimately, that practice contributes to the budget deficit by reducing the Fed's contribution to the general Treasury fund, making the Fed the only Federal bank regulatory agency which shifts examination costs from the institutions being examined to the taxpayer. That's a policy decision that the Fed has made, and I would like to explore the reasoning behind that decision. Under what authority has the Fed declined to charge for bank holding company inspections given that 12 U.S.C. Sec. 1844(c) states that "the Board may make examinations of each bank holding company and each subsidiary thereof, the cost of which *shall* be assessed against, and paid by, such holding company"?

A.4.A. The Bank Holding Company Act requires the Board to use reports prepared by the primary bank supervisor for each bank controlled by a bank holding company to the extent possible, including in any examination of the bank holding company and its affiliates. This requirement was intended to reduce duplication of examinations by the Federal banking agencies, and prevents the double charging of examination fees on banks owned by bank holding companies. In its supervision of bank holding companies, the Federal Reserve has been mindful of the need to minimize duplication and has, in the great majority of cases, relied on examination reports of the primary regulator of each bank controlled by the holding company in evaluating the consolidated strength of the parent company.

Since subsidiary banks account for the vast majority of the assets of bank holding companies, the Board has supplemented the information contained in examination reports with findings obtained through inspections of the holding company and its nonbank subsidiaries. Especially in small institutions, these inspections rely almost entirely on the examination report of the subsidiary bank(s) and focus on intercompany transactions in order to ensure that the parent has not abused its bank(s).

Q.4.B. I have heard the argument that you do not charge for your examinations of banks (as distinguished from bank holding companies) because the Fed does not pay interest on reserves. But is it not true that only State member banks benefit from these free examination services even though national banks contribute more than half of all the bank reserves?

A.4.B. Since 1980, with enactment of the Depository Institution Deregulation and Monetary Control Act (DIDMCA), all depository institutions in the United States have been required to maintain reserves on their domestic deposits at the Federal Reserve. At the end of 1993, domestic deposits of insured commercial banks, thrifts, and U.S. branches and agencies of foreign banks totaled about $3.4 trillion. National banks accounted for roughly $1.4 trillion of that amount, or about 40 percent.

In deciding not to charge State member banks for their supervision, the Federal Reserve has considered not only the revenues it generates from the nonpayment of interest on reserves, but the following factors as well:

(1) The supervision of depository institutions provides substantial benefits to the public by helping to maintain a safe and sound banking and financial system and protecting the public safety net that has been extended to the depository system. In that context, banks are examined primarily to serve a public policy interest, rather than for the benefit of individual banks. Thus, it seems entirely appropriate to finance at least part of the Federal supervisory activities with general Government revenues. Banks, of course, also benefit individually and collectively from governmental supervisory activities. But, in considering that point, it should be recognized that the industry makes payments to regulatory agencies—through zero interest paying reserves, insurance fees, and specific assessments by the OCC and State banking departments—that far exceed the cost of those activities.

(2) State member banks incur the same supervisory and regulatory costs as do nonmember banks. Just as national banks and all other U.S. depository institutions maintain interest-free reserves at the Fed, the FDIC's insurance rates do not distinguish among banks with different charters or membership status. Therefore, the payments by State members and other insured depositories help to cover the FDIC's costs of supervising nonmember banks.

(3) State members (as well as nonmembers) pay assessments to State banking departments for their supervision.

It would seem unfair, therefore, to assess State members and, thereby, to require greater payments of them than of State nonmember banks. Moreover, unlike nonmembers, State member banks are still required to invest in shares of their Federal Reserve Bank. This is a requirement that some institutions have viewed as onerous.

Nevertheless, it is true that national banks not only incur the costs of reserves and deposit insurance, which all federally-insured State-chartered banks pay, but that they also pay explicit supervisory fees to the OCC that are higher than those that State banks pay to their State banking departments. There is a lack of parity. The more suitable way to redress this imbalance, however, should be to seek ways to reduce the heavy cost on national banks.

Q.4.C. How much money did the Federal Reserve collect through its assessments of bank holding companies last year?

A.4.C. As noted above (in response to question 4.A.), the Federal Reserve conducts inspections, rather than examinations. The Federal Reserve does not charge bank holding companies for these inspections.

Q.4.D. How much money does the Federal Reserve spend on its examinations of bank holding companies?

A.4.D. Last year the agency spent about $36 million for its on-site inspections and visitations to bank holding companies.

Q.5.A. The Fed has stated that one of the principal reasons it needs to maintain a large role in bank regulation and supervision is to monitor and contain systemic risk. But aren't most of the systemic risk issues in the banking industry within the purview of the other bank regulators rather than the Fed? For example, isn't it

true that most payment system functions are conducted by banks, and not bank holding companies?

A.5.A. All of the mechanical operations of the payments system occur in banks and not holding companies. And, the Federal Reserve could establish rules—including examination criteria—to be administered by other agencies. But that misses the point. The payments system involves massive intraday credit exposures and in times of crisis becomes the immediate locus of systemic risk and international financial distress. If the Fed is to accomplish its systemic risk responsibilities, it must have hands-on knowledge about how the payments system works—which it obtains from the sample of banks it directly regulates—and the ability to influence banking organizations to behave in certain risk-reducing ways—which it obtains through supervision of holding companies, especially of those organizations active in the payments system. (That is why large dollar transfers is one of three criteria that would bring selected holding companies of large banking organizations under the Fed.)

Q.5.B. Isn't it true that systemic liquidity issues are related to the activities of banks rather than the activities of bank holding companies?

A.5.B. Most of the time, systemic liquidity is focused on banks. (The exception is run-offs of short-term liabilities, e.g., commercial paper at the parent holding company or one of its nonbank subsidiaries.) And, the Fed lends—through the discount window—for liquidity reasons, to banks not directly regulated by it. But, as noted in the answer to question 3.A. above, the Fed could not really understand what another regulator was saying about a bank under its jurisdiction unless it could maintain an experienced staff that itself had hands-on exposure in banking. This is particularly critical since FDICIA requires that the Fed be able to satisfy itself about the solvency of a bank before it can maintain discount window loans to individual banks.

Q.5.C. Isn't it true that most derivatives are traded by banks rather than by their holding companies?

A.5.C. Most of the trading in derivatives in banking organizations occurs at banks. As I said in answer to a question by Senator Bennett on March 2: ". . . We don't need to have major national banks if we have a set of large State member banks in learning, for example, how the derivatives markets work. We are in a number of major State member banks which are dealers in the derivatives markets, and we have learned, to a large extent, how the system works." I might add, with the knowledge base, we must also be able—if there is a problem—to be in *direct* contact with organizations in the derivatives market, which we would maintain through our holding company proposal since virtually all of banks' derivatives trading is at the largest banks.

Q.6. Please explain why the Federal Reserve needs to regulate State member banks, which hold only 15 percent of the Nation's total bank and thrift assets (and an even smaller share of total U.S. assets), in order to conduct monetary policy and control systemic risk.

A.6. As indicated in my response to your first question, to carry out its central bank responsibilities, the Federal Reserve needs to be able to affect events when there is a problem and to have the kind of information about the operation of banking and financial markets that can come only from hands-on supervision of banks. Both the former and some of the latter needs are addressed by supervision and rulemaking for the holding company and nonbank affiliates of significant banking organizations. For complete knowledge about banking operations and feedback, the Fed needs a cross-section of banks of various sizes and locations. State member banks provide that cross-section.

Q.7.A. On March 1, 1994, Secretary Bentsen testified that under the Administration's consolidation proposal, the Treasury would surrender regulatory authority over 62 percent of the Nation's bank and thrift assets in order to establish an independent agency for banking supervision and regulation. Why is the Federal Reserve, for the first time, calling to expand its regulatory jurisdiction?

A.7.A. As indicated in my answer to question 1 and in the attachment to my March 2 statement, the inclusion of State nonmember banks under the Fed's jurisdiction ". . . results solely from the view that in a two agency structure it is desirable that there should be a clear delineation of supervision and regulation responsibility by charter class in order to preserve the dual banking system. The Board makes no case that responsibility for such banks . . . is needed for financial stability and monetary policy. However, some critical mass of banks of various sizes and locations is required if the Fed is to perform its functions effectively."

I should also note that the Fed's proposal would assign about 30 percent of the bank holding companies to the FBC—those whose lead banks have a national charter (except for about 25 significant banking organizations).

Q.7.B. What, in your opinion, is required to assure the new Commission's independence?

A.7.B. This is a difficult question for me on which to reach a judgment. I would say that there are degrees of independence and that the FBC as proposed, while not as independent as the Federal Reserve, would certainly be more independent than the current supervisory structure over national banks and thrifts.

Q.8. Based on your experience as Chairman of an independent agency, what do you believe are the major benefits of having an independent agency conduct bank and thrift regulation?

A.8. The regulatory agencies exist to administer and enforce the Nation's laws and public policies as they pertain to particular industries. To carry out their missions, the agencies must have considerable technical knowledge and insights regarding the industries they regulate. The courts have traditionally recognized the importance of that expertise and have typically provided the agencies with wide latitude to develop and administer their regulations. In order for an agency to be assigned that latitude, however, it is imperative that it not only conduct its activities impartially, but also that the public *perceive* the agency to be conducting its actions fairly, in a manner that prevents abuse or conflicts of interest and that

is free from suspicions that its actions are influenced by undesired political or other special interests and influences.

The importance of that point has been demonstrated throughout our country's history and is also supported by experiences abroad. Time and again, the fair and sound administration of Government has often required that certain governmental activities be insulated from short-term or special interests that can arise through the political process. The creation of the Federal Civil Service and the emergence of regulatory agencies are prime examples.

Much is at stake in assuring the integrity of the regulatory process. The activities and rulings of regulatory agencies affect—often in fundamental, detailed, and direct ways—the operating rules and profitability of major segments of the business community. The responsibilities of such agencies may require its personnel to delve deeply into the daily operations of regulated institutions and to have authority to redirect private actions that are deemed not to be in the public interest. Moreover, in the process of conducting their activities, regulators often gain proprietary information about the regulated organization or its customers that could be misused if disclosed to outsiders. The likelihood of such disclosures could be expected to increase with an agency's loss of independence.

It is particularly important that bank regulatory agencies be given substantial independence. Among regulated industries, commercial banks and other depository institutions perform a central role in the national and world economies. For the economy to function fully and fairly, banks must operate prudently, and must maintain and deserve the public's trust. Failure of the banking system to meet these objectives can present substantial and unnecessary costs to society, in the form of taxpayer assistance, slower economic growth, and unequal opportunities to its citizens. Moreover, in addition to involving a high degree of Government involvement in a bank's affairs, the specific nature of bank supervision requires examiners and other supervisors to make many *subjective* judgments regarding the prudence of a bank's activities and the adequacy of specific operating procedures. Given that type of oversight, it is especially important that the industry's regulator actually be independent and that it be perceived as impartial and free of inappropriate political influence.

The operational and structural independence provided to the Federal Reserve, in particular, has—I believe—served the Nation well, not only in its conduct of monetary policy, but also in the context of its supervisory effort, which is more the focus of your question. The Fed's independence, combined with its other responsibilities as the Nation's central bank, enables the agency to take a broad and, as necessary, long-range perspective when making regulatory policies and ruling on industry requests. Although sometimes unpopular, its positions have been, and continue to be, based on its independent analysis of the facts at hand. Such stable and objective policymaking, developed with due consideration to established public policies and subject to congressional oversight, is critically important in fostering a balanced and consistent performance by the banking system and in promoting a policy framework that encourages investors to make long-term investments in the industry.

Q.9.A. Under 12 U.S.C. Sec. 326, the Federal Reserve is authorized to assess State member banks for the cost of their examinations. However, the Federal Reserve does not exercise its authority to levy such assessments. Consequently, even large State member banks that require significant regulatory resources, such as Morgan Guaranty or Bankers Trust and Chemical Bank, do not pay for their Federal exams. If the Federal Reserve were recouping money from State member banks, the amounts recouped would add to the surplus that the Federal Reserve turns over to the Treasury every year. By failing to assess these charges, the Federal Reserve is, in effect, forcing taxpayers to subsidize the examinations of State member banks. Does the Federal Reserve have any plans to eliminate taxpayers' subsidies of these examinations?

A.9.A. As stated in the response to question 4, the Federal Reserve believes banks are examined and supervised principally for the public's interest, not primarily for the benefit of individual banks. Therefore, the Federal Reserve does not agree that the failure to charge explicit fees for supervising State member banks constitutes a subsidy to these banking organizations by the taxpayer. That point seems particularly valid when it is recognized that these banks—and the banking industry, in general—make nontax payments to their regulators that far exceed the cost of their supervision.

One should further note that, although State member banks are not explicitly assessed for the cost of their Federal supervision, neither are State nonmember banks explicitly assessed for their examinations by the FDIC. Rather, the FDIC finances its supervisory activities of State nonmember banks from its general revenues from deposit insurance premiums levied on all banks and from earnings on the Bank Insurance Fund.

Q.9.B. What is the total amount of this subsidy?

A.9.B. Although its supervisory expenditures are not viewed by the Federal Reserve as a subsidy, last year, we spent about $90 million conducting on-site examinations of State member banks and perhaps a similar amount to conduct off-site supervisory functions pertaining to these institutions.[1]

Q.9.C. What policy justifies this subsidy?

A.9.C. See response to question 4.B. above.

Q.10. On March 4, 1994, Mr. Thomas Schatz, president of Citizen's Against Government Waste, stated before this Committee, "Two regulators would still incorporate wasteful duplication and would also be more likely to engage in a civil war that would result in continued gridlock." What protection does your consolidation proposal offer against these kinds of situations developing?

A.10. I would take issue with Mr. Schatz's statement. Any "duplication" or "gridlock"—which I think would be minimal—would certainly be less than the current four regulator regime. Moreover, I question whether regulatory "efficiency" should be the sole or most important criterion. The nature of the central bank that would re-

[1] Our accounting system does not distribute indirect and more general supervisory costs in this manner.

sult and avoidance of inflexibility and arbitrariness in regulation and supervision are critical to the economy, in my view.

In the Fed proposal, I see no "duplication." There would be two kinds of overlap which are more apparent than real. About 25 large national bank holding companies (and their nonbank affiliates) would be under Fed jurisdiction, while all the banks in these organizations would be supervised by the Federal Banking Commission (FBC). And the Fed would administer national bank rules for about 260 national banks in State bank holding companies, while the FBC would administer Fed rules for about 620 State banks that are part of national bank holding companies. Such administrative burden is modest and transparent to the banking organizations. Our proposal would call for the establishment of common rules, with a public explanation for any deviation. (This and similar issues are discussed in the answer to your question 1.)

Q.11.A. Under your proposal for a single regulator per banking organization, the Federal Reserve would regulate national banks and the Federal Banking Commission would regulate State banks, where such banks are affiliated with a larger institution under the jurisdiction of the Federal Reserve or the Commission. How would you propose to coordinate Federal Reserve regulation of national banks with the Commission's chartering authority?

A.11.A. Under this proposal, the Federal Banking Commission would be the appropriate Federal rulemaking agency for all national banks, and, therefore, would be responsible for issuing rules and interpretations that govern all national banks. The Federal Reserve would be required to apply those rules and interpretations to all national banks that are controlled by holding companies that are under the jurisdiction of the Federal Reserve.

It is expected that the agencies would also consult with each other in areas in which no rule or interpretation by the appropriate rulemaking agency has been issued. In these cases, the decision of the appropriate Federal rulemaking agency would govern.

We also propose that the agencies be required to consult on all examination and reporting rules as well as on major supervisory policies, and that the agencies be required to develop uniform rules for national and State banks where the agencies derive authority for the rules from the same statutory provision and explain any differences in the event that uniform rules are not adopted.

Q.11.B. What, if any, coordination from the Commission would you propose in its regulation of State banks?

A.11.B. The Federal Reserve (and in the case of rules limiting the powers of State banks, the Federal Deposit Insurance Corporation) would be the appropriate Federal rulemaking agency for all State banks, and would issue Federal rules and interpretations governing State banks. The Federal Banking Commission would be required to apply these rules and interpretations to State banks under the Commission's jurisdiction.

As explained above, we also propose that the Federal Banking Commission and the Federal Reserve consult with each other on all examination and reporting rules and major supervisory policies, and develop uniform rules for national and State banks where the agencies derive authority for the rules from the same statutory pro-

vision and explain any differences in the event that uniform rules are not adopted.

Q.12.A. It is our understanding that Mr. William Ryback of the Federal Reserve Board's Division of Supervision and Regulation was contacted as early as 1988 with information that BCCI controlled First American. How many times, from 1977 to 1991, did the Federal Reserve Board have an application, examination, or any other supervisory nexus with First American?

A.12.A. Between 1977 and 1991, the Federal Reserve processed seven applications, conducted 14 full-scope and several special examinations, and took other supervisory actions pertaining to the First American banking organization, including its predecessor, the Financial General banking organization.

The Federal Reserve also had a number of supervisory exchanges with regard to First American and BCCI including the formation, in 1991, of an interagency group to discuss issues surrounding First American and BCCI and any possible enforcement action. Enforcement action taken in 1991 by the Board included issuance of two cease and desist orders and an order of investigation.

Q.12.B. Why did the relationship with BCCI not become known until December 1990?

A.12.B. The Board has, in previous congressional testimony, set forth, in considerable detail, the chronology of its discovery of the relationship between BCCI and CCAH (the holding company for First American). See *The Bank of Credit and Commerce International and S. 1019: Hearing Before the Subcommittee on Consumer and Regulatory Affairs of the Senate Committee on Banking, Housing, and Urban Affairs*, 102d Cong., 1st Sess. 111, 118–120 (1991); *Bank of Credit and Commerce International (BCCI) Investigation, Pt. 2: Hearings Before the House Committee on Banking, Finance and Urban Affairs*, 102d Cong., 1st Sess. 109, 136–42 (1991); *The BCCI Affair: Hearings Before the Subcommittee on Terrorism, Narcotics, and International Operations of the Senate Committee on Foreign Relations, Pt. 1*, 102d Cong., 1st Sess. 79–103 (1991).

Although the Federal Reserve made numerous efforts to substantiate allegations of BCCI control of CCAH, these efforts did not bear fruit until December 1990. As indicated in the above testimony, the inability to determine BCCI's control of CCAH shares earlier is attributable to the deliberate concealment of the ownership of CCAH by BCCI and the fact that the relevant evidence was located overseas, outside the reach of Federal Reserve examiners.

Q.13.A. Please comment on critiques of various aspects of your proposal for consolidation. *First*: The system you propose would be manipulable. Any bank that did not like its regulator could shift its assets in such a way as to recharacterize its lead bank.

A.13.A. We believe that it is important that the Federal system for regulating banks permit at least some choice of regulators by each banking organization. This maintains the strengths of the current system by reducing the likelihood that a single regulator would become too rigid or would be captured by the industry, and by pre-

serving the dual banking system. Accordingly, we would propose that banking organizations be permitted to shift regulators.

To assure that changes in regulator would not undermine effective supervision, we propose a mechanism that requires changes to be a conscious choice of the organization (and not the result of inadvertent, sudden, or temporary changes in the balance sheet of the organization) and that permits the agencies to temporarily override any change in regulators where appropriate to assure the effective supervision of the organization.

As explained above, in response to question 2, this would include defining the size of an institution based on its publicly reported average assets over an extended period of time (for example, eight quarters), limiting switches in supervisors that are based on the asset size of the lead bank to changes at set intervals, and including provisions that permit the Federal Banking Commission and the Federal Reserve to postpone or speed up changes in regulator where appropriate for safety and soundness reasons. In order to assure that enforcement actions are not undermined by a change in regulator, we also propose that the agency that is responsible for any enforcement action be permitted to conclude that action despite a change in regulator, unless the agency agrees to permit the new agency to continue the action.

Q.13.B. *Second*: The system you propose could lead to differential regulation among similarly-chartered institutions.

A.13.B. As explained in response to question 11, we propose that the same agency establish all rules governing depository institutions with the same charter, and that these rules be followed by the other agency. Thus, for example, the Federal Banking Commission would establish all rules and interpretations governing national banks and savings associations and the Federal Reserve would be required to apply these rules and interpretations to all national banks and savings associations under the jurisdiction of the Federal Reserve.

Under our proposal, the Federal Banking Commission and the Federal Reserve Board would also be required to develop uniform rules where the agencies derive authority from the same statutory provisions and explain any differences in rules that are adopted by the agencies. In addition, the Federal Banking Commission and the Federal Reserve would be required to coordinate the development of examination, reporting, and supervisory policies.

Q.13.C. *Third*: The system you propose would force the Federal Reserve into regulation and supervision of institutions over which it has no expertise. Such an absence of expertise would be costly to acquire and would not remove the duplication in our current structure.

A.13.C. Any revision of the current system of Federal supervision would require a new agency to develop new expertise. Under the Federal Reserve's proposal, however, the cost of the Federal Reserve acquiring this expertise would be reduced. The ability of Federal Reserve employees to acquire expertise in the rules that govern national banks is aided by the fact that the Federal Reserve is already required to apply to State member banks a number of the rules that apply to national banks, and has in a number of

other areas adopted rules that are substantially equivalent to the rules that govern national banks. These include the rules governing permissible investments, branching rules, and capital standards. Our examination of those few thrifts in holding company organizations with lead State banks do not pose different problems from banks. We were effective, for example, in broad examinations of the thrifts involved in the Ohio and Maryland difficulties of 1985.

Q.14. You stated in your testimony that the Federal Reserve has used "precisely calibrated techniques" to manage various crises. Please explain what these techniques are, and describe in a step-by-step fashion how the Fed used these techniques in each of the crises that you cite in your testimony. Please include in your answer precisely what was done by the Federal Reserve once it learned of the crisis and how the Federal Reserve relied on the use of its regulatory power over bank holding companies and State member banks to detect the crisis and manage it.

A.14. The observation in its entirety was: "But while rapid liquidity creation [through open market operations and discount window loans] is often a necessary response to a crisis, supervision and regulation responsibilities give the Fed insight and the authority to use less blunt and more precisely calibrated techniques to manage such crises and, more importantly, to avoid them." The attachment to my March 2 statement gave several detailed examples of how the Fed addressed crises. I will not summarize them here, but I will repeat the highlights. In all cases, our role would have been impossible without our knowledge of financial markets and participants *and* the clout to influence events that comes only from a supervisory role.

(a) Our knowledge of the payments system, how banks provide securities credit, and how securities settlement occurs were all pertinent to resolving the Drexel, Burnham failure. The Fed's relationship with banks and holding companies gave it the knowledge as to which personnel to address, how to persuade, and how to fashion procedures to transfer securities and to have credit extended to facilitate an orderly winding-down of the firm.

(b) Again, the Fed played a key role in the 1987 stock market crash by assuring that individual banks were provided with the information and the framework to continue to extend credit and execute payment orders when there was significant doubt about counterparties.

(c) In the mid-1980's thrift crisis, our role was to rapidly examine State-insured thrifts to accelerate their acceptance by the FSLIC for Federal deposit insurance of solvent entities and to assist in the closure and/or merger of insolvent thrifts.

(d) In the 1982 Mexican debt crisis, the Fed recognized that a supervisory focus alone would exacerbate the problem and led the banking community—here and abroad—to participate in loan extensions and expansions that permitted the resolution of the crisis. This example demonstrates the use of clout *and* the special balancing brought to a crisis situation by a supervisor aware of, and responsible for, the economic consequences of its actions.

Q.15. How do you address the issue that, while the Federal Reserve's primary mission is to oversee monetary policy, it also has bank supervisory duties which present inherent conflicts?

Subsequent witnesses have testified that there are at least three ways in which monetary policy and supervisory functions may conflict: (1) bank examinations may conflict with counter-cyclical monetary policy; (2) the two functions compete for the time and energy of policymakers, with bank regulation always taking a back seat to monetary policy; and (3) implementation of both functions by the same agency may involve conflicts of interest with the result that the goals of one are subverted to the goals of the other.

How do you respond to the statement of former Reserve Board Vice Chairman J.L. Robertson that "in appraising the soundness of loans or investments, bank examiners should never be obliged to switch from rose-colored glasses to black ones, and back and forth again, in an effort to implement the monetary policy of the moment"?

A.15. I simply do not see the conflict. Indeed, I believe our monetary policy is improved by the practical knowledge gained from, and the early information we receive through, our examination and supervision of banks. Similarly, I believe that our supervision is vastly improved by our understanding of, and responsibility for, the macroeconomic consequences of our supervisory actions.

As I noted in my statement, ". . . the single regulator . . . would be disconnected from broad economic policy issues. This is a problem because a regulator that does not have macroeconomic responsibility for its actions is likely to inhibit prudent risk-taking by banks, thus limiting economic growth and stability. . . . Trade-offs [between bank failures, and their effect on the economy and the insurance fund, on the one hand, and the economic necessity for banks to finance risk, on the other] are required, and a swing in either direction can create both short- and long-term problems.

"Indeed, a single regulator with a narrow view of safety and soundness and with no responsibility for the macroeconomic implications of its decisions would inevitably have a long-term bias against risk-taking and innovation. It receives no plaudits for contributing to economic growth through facilitating prudent risk-taking, but it is severely criticized for too many bank failures. The incentives are clear.

"The Federal Reserve's stabilization objectives cause us to seek to avoid excessive tightness or ease in our supervisory posture. The former leads inevitably to credit crunches, and the latter to credit policies that contribute, with a lag, to bank losses and failures." With due respect to the late Vice Chairman Robertson, Fed examiners do not ". . . switch rose-colored glasses to black ones. . . ."

Q.16. How do you respond to criticisms we are hearing that the Federal Reserve, as a regulator, is pressuring the industry that it regulates into opposing the Administration's position on regulatory consolidation in order to protect its own turf?

For example, I received a letter from the Association of Community Organizations for Reform Now which reads in pertinent part:

> "I write to express my concern regarding news reports of contacts between the Federal Reserve and the Nation's leading

banks regarding regulatory consolidation and Community Reinvestment Act (CRA) reform.

These press reports have left the unmistakable impression that the Federal Reserve has made a private deal with portions of the banking industry to eviscerate the President's CRA reform initiative in exchange for industry opposition to regulatory consolidation. Indeed, at times the Fed Governors have appeared to go out of their way to organize and agitate the industry on both these public issues.

The appearance of such 'trade' raises concerns about a gross conflict of interest and undermines public confidence in the independence of the Nation's regulatory apparatus. Such backdoor dealmaking between regulated institutions and regulators would be unseemly and wholly inappropriate. It poorly serves the public interest, corrodes public policy, and is a recipe for poor supervisory practices."

The *New York Times* ran a lead article in the business section Saturday, February 26, 1994, which stated: "In a closed meeting with the Federal Reserve's top officials, a dozen of the Nation's most powerful bankers vowed to back the Fed in opposing the Clinton Administration's plan for centralizing bank regulation."

And then earlier, in *The American Banker*, it was reported that a Federal Reserve Board Governor asked banks to oppose the Administration's regulatory consolidation proposal in return for the Fed's opposing the other regulators' CRA recommendations.

There have also been other reports of similar private Federal Reserve Board activity on this issue.

How do you respond to these concerns that, as a regulator, you have been attempting to influence the industry you regulate to support your position on consolidation?

A.16. As I explained to Senator Sarbanes at the hearing that you held regarding the agency consolidation proposals, it is absolutely untrue that the Federal Reserve, as an organization, or I, individually, have attempted in any way to pressure the industry to support the Federal Reserve's position on agency consolidation. The Federal Reserve's views on other regulatory matters are unrelated to our position on consolidation, and any belief that the Board, or any of its members, has tied our views on consolidation to a position regarding any other matter is absolutely false. There is no deal, private or public, expressed or implied, between the Federal Reserve and anyone that in any way ties our position regarding agency consolidation to a position on any other matter. The Federal Reserve's views regarding consolidation arise out of genuine concern regarding the disadvantages of the current proposals regarding agency consolidation and for what the Board firmly believes would be detrimental effects on the Board's ability to carry on its other statutory responsibilities.

The Board is required by law to meet at least four times each year with the Federal Advisory Council, comprised of industry representatives from each of the twelve Federal Reserve districts. By law, this Council confers directly with the assembled Board regarding business conditions, and is empowered to call for information and make recommendations to the Board regarding a variety of matters including "the general affairs of the reserve banking sys-

tem." 12 U.S.C. 262. The FAC takes this opportunity to express directly to the Board views regarding a wide range of matters. Members of the FAC have expressed their views regarding agency consolidation to the Board. This reflects the fact that the agency consolidation proposal is a matter of great importance and interest to the banking industry, and is not in any way an indication that the Federal Reserve has attempted to pressure the industry to support the Board's views. Those who suggest or imply that the Board has entered into any agreement regarding CRA or any other issue with the FAC or with anyone else, or attempted to pressure the industry to support the Board in exchange for Board support regarding CRA or any other issue, are wrong.

As has the Treasury Department, the Office of the Comptroller of the Currency, and a wide variety of other public and private commentators, the Board has expressed its views regarding agency consolidation in a number of public forums in order to further the debate regarding this issue. However, participation in this discussion should in no way be interpreted as an indication that the Federal Reserve has, or would be willing to, change its views on any regulatory, supervisory, or application matter in response to support or opposition from any group or institution or anyone else.

Q.17.A. In your testimony before this Committee on March 2, 1994, you stated that the Federal Reserve Board and the Department of the Treasury were 80 percent on the way toward a final compromise. What have you done since March 2, 1994, to come to terms with your remaining differences?

A.17.A. I have devoted a substantial amount of time and effort on this. Governor LaWare and I have had numerous meetings and exchanges with Under Secretary Newman and Comptroller Ludwig. I have had several discussions with Secretary Bentsen. These conversations commenced within days of March 2 and have involved frank and detailed exchange of proposals. In numerous areas, differences have been overcome and I believe we are close to an overall agreement on the issues.

Q.17.B. When do you project you and the Treasury Department will be prepared to present a united proposal?

A.17.B. It would be my goal and expectation that this would occur soon.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ROTH FROM ALAN GREENSPAN

Q.1. Do you support the consolidation of the OCC and Office of Thrift Supervision? Would such a merger represent at least a good first step?

A.1. I do think that consolidation of the OCC and the OTS is in the public interest, especially as the number of S&L's under OTS jurisdiction declines. It would be a useful step if nothing else is done, but I would prefer the broader consolidation proposal that the Fed has developed.

Q.2. What would be the most rational way for the Federal Reserve and any new Federal Banking Commission to divide their regulatory authority? Would it make any sense, for instance, for the

Fed to oversee all bank holding companies and their subsidiaries, with the rest to be delegated to the FBC? What percentage of all banking assets would be under the Fed's supervision if this were done?

A.2. We have suggested that all banking organizations—with some exceptions—be divided on the basis of the charter class of the lead (largest) bank in the organization. Thus, the proposed Federal Banking Commission would be the supervisor for (1) all independent national banks, and all national and State-chartered thrifts, and all thrift holding companies; and (2) all bank holding companies, the nonbank subsidiaries, and *all* bank subsidiaries (regardless of charter class) of banking organizations whose lead bank has a national charter, *except* that the small number of holding companies and nonbank subsidiaries (but not the bank subsidiaries) of those national bank holding companies that meet certain criteria of significant financial scale in total or in foreign exchange or payments services be under the purview of the Fed. The Federal Reserve would be the supervisor for (1) all independent State banks and (2) all bank holding companies, their nonbank subsidiaries, and *all* bank subsidiaries (regardless of charter class) of banking organizations whose lead bank is State-chartered, *plus* those national bank holding companies referred to in the exception of the previous sentence. Note that in all cases, other than for a small number of large national bank organizations, there would be only one supervisor per organization.

It would not, I think, be reasonable to allocate among regulators on the basis of banking organizations with holding company parents, on the one hand, and independent banks, on the other. Over 25 percent of banks are not in bank holding companies—distributed among all charter classes—but those banks account for only a bit over 8 percent of bank assets. Such banks would be relatively heterogenous and small and are not a relevant group for a separate regulator. It would also make the Fed too powerful a regulator if it was responsible for all *banks* in holding companies.

Q.3. In the proposal delineated for the Committee, you suggest that the Fed serve as supervisor for all independent State banks and all bank holding companies whose lead bank is State-chartered. While the latter category seems to me appropriate for Fed supervision, it would also seem to me that the FDIC might be a more appropriate Federal supervisor of independent State banks, whose primary Federal nexus is their deposit insurance. Do you disagree?

A.3. If there were a three regulator world, *independent* State nonmembers (those not in holding companies) would be a more relevant group, but there are less than 2,000 of these organizations (17 percent of the total) with only $207 billion of assets (5.5 percent of the total). The logic of separate regulators for independent banks, however, is made more difficult by their small number and limited uniqueness. There are far more one-bank holding companies—most of which are shell holding companies (no nonbank subsidiaries)—whose organizations are more similar to the independents. The State nonmember independent and the State nonmember shell one-bank holding companies would total over 40 percent of banks with about 13 percent of bank assets. While perhaps a more

reasonable grouping, I would prefer to make the split between only two supervisors and by charter class, leaving the FDIC to handle deposit insurance and resolution of insolvent institutions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BOND FROM ALAN GREENSPAN

Q.1. Do you feel that your plan will mean a reduction in regulatory burden for the banking industry? If so, why does there seem to be so little industry support for consolidation proposals? Secretary Bentsen said yesterday that there has been a lot of misunderstanding about their proposal. Do you agree? How do you explain the industry's lack of support for either plan?

A.1. The reduction in regulatory burden would occur only for those organizations that now must deal, in a significant way, with two or more regulators. Most of these entities are quite large. Smaller- and medium-sized banks now deal with only one Federal regulator on *most* of their operations and, hence, would be *relatively* unaffected by regulatory consolidation. For them, regulatory relief would thus be modest.

The large organizations would, I think, have some regulatory relief—considerable in some cases. However, I think these entities (as well as most other banks) have become more concerned about having no choice of Federal regulator and having to deal with only a single regulator that would tend, over time, to become inflexible and arbitrary. When they balance regulatory relief against such concerns, the problem of multiple regulation recedes to the background. In my view, most bankers have understood these proposals but, unfortunately, have been a bit nervous about offending either the Treasury or the Fed by speaking out.

Q.2. Currently, the Fed does not regulate thrifts, yet under the Fed proposal if a thrift was a part of a bank holding company whose lead bank was a State-chartered bank, the Fed would regulate that thrift. The Fed doesn't have any expertise in regulating thrifts, so why should Congress pass a plan that would allow the Fed to regulate thrifts as a part of a bank holding company structure?

A.2. Under the Fed plan, thrifts that were in bank holding companies whose lead bank was State-chartered would—along with all other affiliates—be supervised by the Fed. This provides the sought-after benefit of one supervisor per organization. The Fed would administer the thrift rules established by the Federal Banking Commission. We believe our supervisors—from their banking experience—could do a professional job of examination of thrifts, since banks can hold virtually all the assets that thrifts can, and could easily administer Commission rules.

Q.3. The Administration claims that their plan will prevent future credit crunches and problems like the savings and loan debacle. Do you agree? Will your plan prevent future credit crunches and problems like the savings and loan debacle? Please explain.

A.3. I do not understand the Administration's claim that the greater supervisory focus of a single regulator will prevent future credit crunches or problems like the savings and loan debacle. The issue is not, as has been claimed, the focus on safety and soundness by a single purpose agency. The issue is good supervision in a sound

economy. Indeed, I would argue that supervision is improved if the agency has a significant responsibility for the macroeconomic consequences of its actions. I submit that the Fed has been a more consistent long-run supervisor for just such a reason and, in a two regulator world, the Fed could be a useful constraint to keep the other agency from veering too far toward excess regulatory ease—with the incentive for long-run portfolio problems and associated future reductions in credit availability—or excess regulatory restraints—with the incentive for near-term credit crunches and a weak economy.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BOXER FROM ALAN GREENSPAN

Q.1. The recent merger between Banc One and Valley National Bancorp was highly criticized by African and Latino organizations who noted that these institutions:

a. had no Latino board members, despite serving California, Texas, and Arizona;

b. had made no business loans to African American businesses, and;

c. had demonstrated no programs designed to reach low-income or minority residents.

Are you aware of this specific case? How do you respond to the assertion that this case is an important example of lax enforcement of CRA by the Fed?

A.1. As seen by the attached Board Order, dated March 1, 1993, I voted, along with other Board members, to approve the application of Banc One Corporation, Columbus, OH, to acquire Valley National Corporation, Phoenix, AZ. The Board carefully reviewed the CRA performance records of Banc One and Valley National and their respective subsidiary banks, the comments presented in written submissions, and Banc One's and Valley National's responses to those comments, and other relevant facts of record. As the Order outlines, the Board considered the comments of approximately 60 organizations and individuals, about half of whom submitted statements supporting the proposal, primarily on the basis of the CRA record of the Banc One organization. As part of a thorough review of the CRA record of the two organizations involved in the proposal, the Board noted that the most recent CRA performance examinations for Banc One's subsidiary banks showed 19 "outstanding" ratings and 41 "satisfactory" ratings. Before acting on the proposal, the Board considered the preliminary results of a very current examination by the OCC of Banc One's subsidiary in Cleveland, OH. The Board weighed the "needs to improve" rating of the Cleveland subsidiary, which represented less than 5 percent of consolidated assets, against the overall satisfactory record of Banc One's other subsidiaries. Also, as part of the Federal Reserve's review of the record, during the processing of the application, examiners from the Federal Reserve participated with the OCC in examining the CRA record of Valley. To fully and carefully consider the issues in this application, the Board took longer than its normal 60-day process before acting on the application.

To address your specific points, please note, as stated in footnote 11 of the Order, that the Board fully supports affirmative programs designed to promote equal opportunity in every aspect of a bank's personnel policies and practices. However, the ethnic diversity within senior management and the boards of directors are not factors that legally relate to the record of performance under the CRA. The Board believes such issues are beyond the scope of the factors that may be assessed under the CRA or the convenience and needs factor of the Bank Holding Company Act. Regarding the issues of business loans to African American businesses, it is currently against the law to collect such racial data for business loans. However, as the Order states, the Board reviewed the applicant's participation in programs aimed at minority business. The Order also outlines many efforts by Banc One to serve low-income and minority residents.

Q.2. In June of 1993, the Boston Federal Reserve Bank Study, entitled "Closing the Gap," showed a direct link between a lack of diversity within the management of an institution and a poor record on minority lending.

Mr. Chairman, do you support disclosure of race and gender make up of a lending institution's board of directors and top management as part of CRA exams and merger applications?

A.2. The Federal Reserve Bank of Boston's publication, "Closing the Gap," is a comprehensive guide for lenders who seek to ensure that all loan applicants are treated fairly and to expand their markets to reach a more diverse customer base. The Reserve Bank gathered recommendations on "best practice" from lending institutions and consumer groups. The section outlining recommendations on hiring and promotion practices states that:

> Hiring and promotion practices that foster racial and ethnic diversity can help a financial institution gain a competitive edge in cultivating business in underserved markets. A staff that encompasses a variety of viewpoints and experience can create an environment in which minority applicants feel welcome, strengthen ties to minority communities, and design policies and products that more effectively meet the needs of minority customers. Moreover, by explicitly encouraging employees and directors to participate in community development activities, institutions demonstrate their commitment to serving minority communities to both staff members and the public.

In addition, the Board, along with other Federal agencies, recently addressed employment practices in a joint policy statement on lending discrimination. Question 10 of the attached March 8, 1994, Federal Agencies Joint Policy Statement on Lending Discrimination states that, although not a violation of the Fair Housing Act or the Equal Credit Opportunity Act, the employment of few minorities and others in protected classes can contribute to a climate in which lending discrimination could occur by affecting the delivery of services. The policy statement also provides recommendations to encourage diverse employment practices.

While I fully support the concepts in these documents, the statutes covering CRA examinations or merger applications, as currently structured, do not call for such disclosure. Moreover, the im-

portance of the diversity of boards of directors and top management goes far beyond financial institutions, and it is not clear to me why they would be singled out for specific treatment.

Q.3. Currently, we require race and gender disclosures for home mortgage loans.

Would you support a race and gender disclosure requirement for small business and consumer loans, as part of CRA reform? Do you believe there is discrimination for lending for homes but not for businesses?

A.3. The Board strongly opposes discrimination in any aspect of lending. The Board believes that, generally, the purpose of fair lending laws is best served when an evaluation of creditworthiness is colorblind and gender neutral. The Board is concerned that collecting race and gender information for business and consumer loans chips away at the fundamental premise that such information is irrelevant to the credit-granting process.

The Board has some practical concerns about the usefulness of race and gender information on business loans (whether collected as a part of CRA reform or under other fair lending laws). For example, to collect data on loans to partnerships or corporations, rules regarding the demographic make up of partners or shareholders would be required. Simple rules that ease compliance are likely to produce generalized data that may be too imprecise for statistical analysis. On the other hand, requiring detailed information about all shareholders of a corporation seems unworkable.

Also, the potential for isolating race or gender as a factor in a credit decision for a home loan is much higher than for a business loan. The credit criteria used to evaluate the ability of a consumer to repay a home loan—essentially, the value of the home, the borrower's income and credit history—is much more uniform than the criteria used for a business loan applicant. For example, factors such as a business applicant's expertise, competition, and collateral may vary widely. Thus, the Board is concerned about the utility of the data, in comparison with the burden of collecting it.

Q.4. Mr. Chairman, it is my understanding that among the Federal Reserve's top policymakers only 1 percent are Latinos and 4 percent are African American.

Are you taking steps to hire more minorities for top policy positions? Do you believe that the Fed's lack of diversity impacts its sensitivity to issues of importance to minorities?

A.4. As I have stated before in congressional testimony, one area in which I see major need for change is the inadequate pace at which women and minorities have moved into the top echelons of the Federal Reserve. We share your concerns in this regard, and are working diligently to improve opportunities for women and minorities throughout the System. Although I am concerned about diversity, I do not believe it impacts the sensitivity by the Board to issues of importance to minorities.

As a matter of information, currently 12 percent of the Board's top staff positions (the official staff) are minorities, which is a higher percentage than in the Federal Government, as a whole, or in comparable agencies. Three percent of those officers are Hispanic and eight percent are African American.

Q.5. Andrew Brimmer, former member of the Federal Reserve Board, testified before this Committee last year that the current regulatory system contributed to the credit crunch of 1990–91?

Do you agree with Mr. Brimmer's assessment? If so, how did it contribute?

A.5. More important than the "regulatory system" in contributing to supply constraints on bank credit in 1990–91 were (1) the previous credit losses that had depleted bank capital and contributed to well publicized bank failures, (2) FDICIA, which both escalated the importance of capital and raised the bank cost of capital shortfalls and risk-taking, and (3) bank desires to exceed minimum regulatory capital, given previous experience and the focus on capital. In an important sense, these were transitional problems to a new structure that are now, happily, behind us.

This having been said, I have no doubt that supply constraints were exacerbated as the field supervisors of all agencies, having been criticized for the high failure rates of banks, in an understandable human response, were much more stringent than either previously or than called for by the situation. I think this, too, is behind us. But, I would also note, that is one of the reasons why the Fed should stay active and play a major role in bank supervision: We are the only agency that has a macroeconomic responsibility for our supervision and regulation. As such, we tend to be more even-keeled than those agencies with a sole focus on bank safety and soundness.

Q.6. Is it possible that a single regulator could prove to exacerbate the regulatory climate in which foreign banks operate in the U.S.? Could that cause a backlash against U.S. banks which operate (or seek to operate) internationally?

A.6. Foreign banks operate in the United States under the same dual banking system as domestic banks. For example, a foreign bank may establish a branch or agency under either a Federal license or a State license. Similarly, a U.S. bank subsidiary of a foreign bank has the choice of a State or national charter. Consequently, the disadvantages of a single Federal regulator on the dual banking system will also accrue to foreign banks.

It is to be hoped that whatever changes the United States may choose to adopt in its regulatory structure would not have a disparate impact on foreign banks. If such changes did have a disparate impact, however, foreign authorities would be likely to view such impact unfavorably. It is difficult to predict whether U.S. banks would suffer retaliation as a result, although it cannot be ruled out.

Q.7. Is there not the possibility that the Federal Banking Commission could become a monolithic agency which is unresponsive to the needs of the smaller, locally oriented State banks? Would that not hurt underserved communities which rely, in large part, on local institutions?

A.7. I agree with you. However, the problem of unresponsiveness would be an issue for *all* banks. It is in the very nature of such agencies. The relative impact could, as you suggest, be the largest in those communities with the fewest alternative sources of funding.

ATTACHMENTS

Interagency Task Force On Fair Lending

U.S. Department of Housing and Urban Development
U.S. Department of Justice
Office of the Comptroller of the Currency
Office of Thrift Supervision
Federal Reserve System
Federal Deposit Insurance Corporation
Federal Housing Finance Board
Federal Trade Commission
National Credit Union Administration
Office of Federal Housing Enterprise Oversight

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FEDERAL AGENCIES ADOPT JOINT POLICY STATEMENT ON LENDING DISCRIMINATION

WASHINGTON, D.C. -- Top officials of the 10 federal government agencies responsible for implementing and enforcing the nation's fair lending laws today announced a policy statement on discrimination in lending.

This was the first meeting of the Interagency Task Force on Fair Lending, which was organized to develop a coordinated approach to address discrimination in lending.

The participating federal agencies and their principals included:

- The Department of Housing and Urban Development -- Secretary Henry G. Cisneros
- The Department of Justice -- Attorney General Janet Reno
- The Office of the Comptroller of the Currency -- Comptroller Eugene A. Ludwig
- The Board of Governors of the Federal Reserve -- Governor Lawrence B. Lindsey
- The Office of Thrift Supervision -- Acting Director Jonathan L. Fiechter
- The Federal Deposit Insurance Corporation -- Acting Chairman Andrew C. Hove, Jr.
- The Federal Housing Finance Board -- Acting Chairman Nicolas P. Retsinas
- The National Credit Union Administration -- Chairman Norman E. D'Amours
- The Federal Trade Commission -- Christian S. White, Acting Director, Bureau of Consumer Protection
- The Office of Federal Housing Enterprise Oversight -- Director Aida Alvarez

"This is an historic occasion," said Henry G. Cisneros, Secretary of the Department of Housing and Urban Development. "Today, the full weight of the U.S. government has been brought to bear to assure fair lending to all Americans. The agencies that oversee lenders of all kinds have joined forces with HUD and the Department of Justice, the two government agencies that enforce civil rights, in a joint declaration against discrimination in lending."

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Attorney General Janet Reno added: "This is the first time that these enforcement and regulatory agencies have spoken with one voice on the critical issue of lending discrimination. While we will enforce the law vigorously, a major thrust of our program is to promote voluntary compliance. The Justice Department will work with the Task Force to continue its efforts to provide further guidance to the industry."

"This is the beginning of the process. We are looking forward to receiving comments about how these principles will apply to individual businesses and consumers, and we expect to provide additional clarification in the future," said Federal Reserve Governor Lawrence B. Lindsey.

"By clarifying the basic principles that all the federal agencies will use in identifying discrimination, this policy statement will benefit everyone -- lenders, consumers, and regulators alike," said Eugene A. Ludwig, Comptroller of the Currency. "In addition, the policy statement will help guarantee a level playing field for all borrowers by applying the same principles not just to banks and thrifts but to everyone who makes loans."

"Discrimination on a prohibited basis is intolerable and socially and economically destructive. Because the contours of the law are often not well defined, depository institutions and other lenders are not always certain what action might be considered to constitute illegal discrimination. The objective of the policy statement is to further the process of providing more guidance and concrete examples of what is and is not illegal discrimination," Jonathan L. Fiechter, Acting Director of the Office of Thrift Supervision, said.

The task force policy statement on fair lending describes what constitutes discrimination under the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. It is being issued to inform lenders about what factors the agencies consider in determining whether lending discrimination exists, and to provide the agencies with a foundation for future interpretations and rulemakings. The statement will be used by the agencies as a tool for administrative enforcement of fair lending statutes. The policy statement applies to all lenders, including banks and thrifts, credit unions, mortgage brokers, finance companies, retailers, credit card issuers and any other persons or entities who extend credit of any type.

The policy statement describes the ECOA and Fair Housing Act and identifies specific discriminatory practices prohibited by these laws. It continues with a description of the three methods of proving lending discrimination under these statutes -- overt evidence of discrimination, evidence of disparate treatment and evidence of disparate impact.

Overt discrimination and disparate treatment have long been viewed as common methods of lending discrimination under the ECOA and the Fair Housing Act. In its policy statement, the Task Force states that evidence of disparate impact in lending could also constitute discrimination under those laws when a lender cannot show that a "business necessity" exists.

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Lenders' most commonly asked questions about fair lending violations are addressed in the final section. Answers to these questions include a detailed discussion of the criteria the agencies will use in determining the nature and severity of sanctions to address discriminatory lending practices, and the conditions under which the primary regulatory agencies will make referrals for investigation and enforcement. Application of the principles outlined in the policy statement will depend on the facts in each case and is subject to continuing development.

"The FDIC continues to place a high priority on Fair Lending and has recently enlarged its examination force to strengthen compliance with this important legislation. I am pleased that the FDIC can be part of this united effort to clarify and enhance the requirements that financial institutions must satisfy to meet both the spirit and letter of the law, and I have recommended to the FDIC Board adoption of the statement," said Andrew C. (Skip) Hove, Jr., Acting Chairman of the Federal Deposit Insurance Corporation.

"I am glad that President Clinton has formally recognized the perniciousness of discrimination in the lending community and has focused our attention on this critical issue. I believe the credit union industry's fair lending record will always be second to none. But no matter how good we think the financial industry is at making credit available to all who desire and deserve that credit, we know it can do better," Norman E. D'Amours, Chairman of the National Credit Union Administration, stated.

"If the Federal Home Loan Bank System is to fulfill its public purpose, member institutions must operate in a non-discriminatory manner," said Nicolas P. Retsinas, Acting Director of the Federal Housing Finance Board, which oversees the Bank System. "For this reason, the Finance Board wholeheartedly endorses the fair lending policy statement. We see it as a bold and timely reaffirmation of the principles which must characterize all aspects of our housing finance system."

Three agencies, the Federal Deposit Insurance Corporation, National Credit Union Administration and Federal Trade Commission, will soon vote on adopting the policy statement. The statement will then be published in the *Federal Register* and is effective upon publication. The agencies welcome comments and questions about the application of the statement's principles to lenders' specific policies and practices.

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INTERAGENCY TASK FORCE ON FAIR LENDING

POLICY STATEMENT

The Interagency Task Force on Fair Lending met on March 8, 1994 to consider the following Policy Statement on Discrimination in Lending. The Department of Housing and Urban Development, the Department of Justice, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Housing Finance Board, and the Office of Federal Housing Enterprise Oversight have adopted the Policy Statement. Governor Lawrence Lindsey was authorized by the Board of Governors of the Federal Reserve System to adopt the Policy Statement on behalf of the Board of Governors and has done so. The participants in the Task Force meeting representing the Board of the Federal Deposit Insurance Corporation, the Board of the National Credit Union Administration, and the Federal Trade Commission fully support the Policy Statement and have agreed to seek approval of the Policy Statement from their agencies. The Task Force participants have agreed that the Policy Statement may be made public pending this process. Upon completion of this process, the Policy Statement will be published in the Federal Register as a Notice. The Notice will state that the agencies welcome comments about the application of the principles in the Policy Statement to specific policies and practices. The agencies anticipate providing further clarification and elaboration on the application of these principles in the future.

Policy Statement on Discrimination in Lending

The Department of Housing and Urban Development ("HUD"), the Department of Justice ("DOJ"), the Office of the Comptroller of the Currency ("OCC"), the Office of Thrift Supervision ("OTS"), the Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation ("FDIC"), the Federal Housing Finance Board ("FHFB"), the Federal Trade Commission ("FTC"), the National Credit Union Administration ("NCUA"), and the Office of Federal Housing Enterprise Oversight ("OFHEO") (collectively, "the Agencies") are concerned that some prospective home buyers and other borrowers may be experiencing discriminatory treatment in their efforts to obtain loans. The 1992 Federal Reserve Bank of Boston study on lending discrimination, Congressional hearings, and agency investigations have indicated that race is a factor in some lending decisions. Discrimination in lending on the basis of race or other prohibited factors is destructive, morally repugnant, and against the law. It prevents those who are discriminated against from enjoying the benefits of access to credit. The Agencies will not tolerate lending discrimination in any form. Further, fair lending is not inconsistent with safe and sound operations. Lenders must continue to ensure that their lending practices are consistent with safe and sound operating policies.

This policy statement applies to all lenders, including mortgage brokers, issuers of credit cards, and any other person who extends credit of any type. The policy statement is being issued for several reasons, including:

- To provide guidance about what the agencies consider in determining if lending discrimination exists; and

- To provide a foundation for future interpretations and rulemakings by the Agencies.

A number of federal statutes seek to promote fair lending. For example, the Home Mortgage Disclosure Act ("HMDA") seeks to prevent lending discrimination and redlining by requiring public disclosure of certain information about mortgage loan applications. The Community Reinvestment Act ("CRA") seeks affirmatively to encourage institutions to help to meet the credit needs of the entire community served by each institution covered by the statute, and CRA ratings take into account lending discrimination by those institutions. The Americans with Disabilities Act prohibits discrimination against persons with disabilities in the provision of goods and services, including credit services. This policy statement, however, is based upon and addresses only the Equal Credit Opportunity Act and the Fair Housing Act, the two statutes that specifically prohibit discrimination in lending.

This policy statement has been approved and adopted by the signatory Agencies listed above as a statement of the Agencies' general position on the Equal Credit Opportunity Act and the Fair Housing Act for purposes of administrative enforcement of those statutes. It is intended to be consistent with those statutes and their implementing regulations and to provide

guidance to lenders seeking to comply with them. It does not create or confer any substantive or procedural rights on third parties which could be enforceable in any administrative or civil proceeding.

This policy statement will discuss what constitutes lending discrimination under these statutes and answer questions about how the Agencies will respond to lending discrimination and what steps lenders might take to prevent discriminatory lending practices.

A. Lending Discrimination Statutes and Regulations

(1) The Equal Credit Opportunity Act ("ECOA") prohibits discrimination in any aspect of a credit transaction. The ECOA is not limited to consumer loans. It applies to any extension of credit, including extensions of credit to small businesses, corporations, partnerships, and trusts.

The ECOA prohibits discrimination based on:

- Race or color;
- Religion;
- National origin;
- Sex;
- Marital status;
- Age (provided the applicant has the capacity to contract);
- The applicant's receipt of income derived from any public assistance program; and
- The applicant's exercise, in good faith, of any right under the Consumer Credit Protection Act.

The Federal Reserve Board's Regulation B, found at 12 C.F.R. Part 202, implements the ECOA. Regulation B describes lending acts and practices that are specifically prohibited, permitted, or required. Official interpretations of the regulation are found in Supplement I to 12 C.F.R. Part 202.

(2) The Fair Housing Act ("FH Act") prohibits discrimination in all aspects of residential real-estate related transactions, including, but not limited to:

- Making loans to buy, build, repair or improve a dwelling;
- Purchasing real estate loans;
- Selling, brokering or appraising residential real estate; and
- The sale or rental of a dwelling.

The FH Act prohibits discrimination based on:

- Race or color;
- National origin;
- Religion;
- Sex;
- Familial status (defined as children under the age of 18 living with a parent or legal custodian, pregnant women and people securing custody of children under 18); and
- Handicap.

HUD's regulations implementing the FH Act are found at 24 C.F.R. Part 100.

Because both the FH Act and the ECOA apply to mortgage lending, lenders may not discriminate in mortgage lending based on any of the prohibited factors in either list.

Liability under these two statutes for discrimination on a prohibited basis is civil, not criminal. However, there is criminal liability under the FH Act for various forms of interference with efforts to enforce the FH Act, such as altering or withholding evidence or forcefully intimidating persons seeking to exercise their rights under the FH Act.

What is prohibited. Under the ECOA, it is unlawful for a lender to discriminate on a prohibited basis in any aspect of a credit transaction and, under both the ECOA and the FH Act, it is unlawful for a lender to discriminate on a prohibited basis in a residential real estate related transaction. Under one or both of these laws, a lender may not, because of a prohibited factor:

- Fail to provide information or services or provide different information or services regarding any aspect of the lending process, including credit availability, application procedures, or lending standards;

- Discourage or selectively encourage applicants with respect to inquiries about or applications for credit;

- Refuse to extend credit or use different standards in determining whether to extend credit;

- Vary the terms of credit offered, including the amount, interest rate, duration, or type of loan;

- Use different standards to evaluate collateral;

- Treat a borrower differently in servicing a loan or invoking default remedies; or

- Use different standards for pooling or packaging a loan in the secondary market.

A lender may not express, orally or in writing, a preference based on prohibited factors or indicate that it will treat applicants differently on a prohibited basis.

A lender may not discriminate on a prohibited basis because of the characteristics of:

- A person associated with a credit applicant (for example, a co-applicant, spouse, business partner, or live-in aide); or

- The present or prospective occupants of the area where property to be financed is located.

Finally, the FH Act requires lenders to make reasonable accommodations for a person with disabilities when such accommodations are necessary to afford the person an equal opportunity to apply for credit.

B. Types of Lending Discrimination

The courts have recognized three methods of proof of lending discrimination under the ECOA and the FH Act:

- "Overt evidence of discrimination," when a lender blatantly discriminates on a prohibited basis;

- Evidence of "disparate treatment," when a lender treats applicants differently based on one of the prohibited factors; and

- Evidence of "disparate impact," when a lender applies a practice uniformly to all applicants but the practice has a discriminatory effect on a prohibited basis and is not justified by business necessity.

Overt Evidence of Discrimination. There is overt evidence of discrimination when a lender openly discriminates on a prohibited basis.

> **Example.** A lender offered a credit card with a limit of up to $750 for applicants aged 21-30 and $1500 for applicants over 30. This policy violated the ECOA's prohibition on discrimination based on age.

There is overt evidence of discrimination even when a lender expresses -- but does not act on -- a discriminatory preference:

> **Example.** A lending officer told a customer, "We do not like to make home mortgages to Native Americans, but the law says we cannot discriminate and

we have to comply with the law." This statement violated the FH Act's prohibition on statements expressing a discriminatory preference.

Evidence of Disparate Treatment. Disparate treatment occurs when a lender treats a credit applicant differently based on one of the prohibited bases. Disparate treatment ranges from overt discrimination to more subtle disparities in treatment. It does not require any showing that the treatment was motivated by prejudice or a conscious intention to discriminate against a person beyond the difference in treatment itself. It is considered by courts to be intentional discrimination because no credible, nondiscriminatory reason explains the difference in treatment on a prohibited basis.

> **Example.** Two minority loan applicants were told that it would take several hours and require the payment of an application fee to determine whether they would qualify for a home mortgage loan. In contrast, a loan officer took financial information immediately from nonminority applicants and determined whether they qualified in minutes, without a fee being paid. The lender's differential treatment violated both the ECOA and the FH Act.

> **Example:** Redlining refers to the illegal practice of refusing to make residential loans or imposing more onerous terms on any loans made because of the predominant race, national origin, etc., of the neighborhood in which the property is located. Redlining violates both the FH Act and the ECOA.

Disparate treatment may more likely occur in the treatment of applicants who are neither clearly well-qualified nor clearly unqualified. Discrimination may more readily affect applicants in this middle group for two reasons. First, because the applications are all "close cases," there is more room and need for lender discretion. Second, whether or not an applicant qualifies may depend on the level of assistance the lender provides the applicant in preparing an application. The lender may, for example, propose solutions to problems on an application, identify compensating factors, and provide encouragement to the applicant. Lenders are under no obligation to provide such assistance, but to the extent that they do, the assistance must be provided in a nondiscriminatory way.

> **Example:** A nonminority couple applied for an automobile loan. The lender found adverse information in the couple's credit report. The lender discussed the credit report with them and determined that the adverse information, a judgment against the couple, was incorrect since the judgment had been vacated. The nonminority couple was granted their loan. A minority couple applied for a similar loan with the same lender. Upon discovering adverse information in the minority couple's credit report, the lender denied the loan application on the basis of the adverse information without giving the couple an opportunity to discuss the report.

> **Example:** Two minority borrowers inquired with a lender about mortgage loans. They were given applications for fixed-rate loans only and were not offered assistance in completing the loan applications. They completed the applications on their own and ultimately failed to qualify. Two similarly situated nonminority borrowers made an identical inquiry about mortgage loans to the same lender. They were given information about both adjustable-rate and fixed-rate mortgages and were given assistance in preparing applications that the lender could accept.

Both of these are examples of disparate treatment of similarly situated applicants, apparently based on a prohibited factor, in the amount of assistance and information the lender provided. The lender might also generally exercise its discretion to disfavor some individuals or favor others in a manner that results in a pattern or practice of disparate treatment that cannot be explained on grounds other than a prohibited basis.

If a lender has treated similar applicants differently on the basis of a prohibited factor, it must provide an explanation for the difference in treatment. If the lender is unable to provide a credible and legitimate nondiscriminatory explanation, the agency may infer that the lender discriminated.

If an agency determines that a lender's explanation for treating some applicants differently is a pretext for discrimination, the agency may find that the lender discriminated, notwithstanding the lender's explanation.

> **Example:** A lender rejected a loan application made by a female applicant with flaws in her credit report but accepted applications by male applicants with similar flaws. The lender offered the explanation that the rejected application had been processed by a new loan officer who was unfamiliar with the bank's policy to work with applicants to correct credit report problems. However, an investigation revealed that the same loan officer that processed the rejected application had accepted applications from males with similar credit problems after working with them to provide satisfactory explanations.

When a lender's treatment of two applicants is compared, even when there is an apparently valid explanation for a particular difference in treatment, further investigation may establish disparate treatment on a prohibited basis. For example, seemingly valid explanations for denying loans to minority applicants may have been applied consistently to minority applicants and inconsistently to nonminority applicants; or "offsetting" or "compensatory" factors cited as the reason for approving nonminority applicants may involve information that the lender usually failed to consider for minority applicants but usually considered for nonminority applicants.

A pattern or practice of disparate treatment on a prohibited basis may also be established through a valid statistical analysis of detailed loan file information, provided that the analysis

controls for possible legitimate explanations for differences in treatment. Where a lender's underwriting decisions are the subject of a statistical analysis, detailed information must be collected from individual loan files about the applicants' qualifications for credit. Data reported by lenders under the HMDA do not, standing alone, provide sufficient information for such an analysis because they omit important variables, such as credit histories and debt ratios. HMDA data are useful, though, for identifying lenders whose practices may warrant investigation for compliance with fair lending laws. HMDA data may also be relevant, in conjunction with other evidence, to determine whether a lender has discriminated.

Evidence of Disparate Impact. When a lender applies a policy or practice equally to credit applicants, but the policy or practice has a disproportionate adverse impact on applicants from a group protected against discrimination, the policy or practice is described as having a "disparate impact." Policies and practices that are neutral on their face and that are applied equally may still, on a prohibited basis, disproportionately and adversely affect a person's access to credit.

Although the precise contours of the law on disparate impact as it applies to lending discrimination are under development, it has been clearly established that proof of lending discrimination using a disparate impact analysis encompasses several steps. The single fact that a policy or practice creates a disparity on a prohibited basis is not alone proof of a violation. Where the policy or practice is justified by "business necessity" and there is no less discriminatory alternative, a violation of the FH Act or the ECOA will not exist.

The existence of a disparate impact may be established through review of how a particular practice, policy or standard operates with respect to those who are affected by it. The existence of disparate impact is not established by a mere assertion or general perception that a policy or practice disproportionately excludes or injures people on a prohibited basis. The existence of a disparate impact must be established by facts. Frequently this is done through a quantitative or statistical analysis. Sometimes the operation of the practice is reviewed by analyzing its effect on an applicant pool; sometimes it consists of an analysis of the practice's effect on possible applicants, or on the population in general. Not every member of the group must be adversely affected for the practice to have a disparate impact. Evidence of discriminatory intent is not necessary to establish that a policy or practice adopted or implemented by a lender that has a disparate impact is in violation of the FH Act or ECOA.

Identifying the existence of a disparate impact is only the first step in proving lending discrimination. When an Agency finds that a lender's policy or practice has a disparate impact, the next step is to seek to determine whether the policy or practice is justified by "business necessity." The justification must be manifest and may not be hypothetical or speculative. Factors that may be relevant to the justification could include cost and profitability.

Even if a policy or practice that has a disparate impact on a prohibited basis can be justified by business necessity, it still may be found to be discriminatory if an alternative policy or practice could serve the same purpose with less discriminatory effect.

> **Example:** A lender's policy is not to extend loans for single family residences for less than $60,000.00. This policy has been in effect for ten years. This minimum loan amount policy is shown to disproportionately exclude potential minority applicants from consideration because of their income levels or the value of the houses in the areas in which they live. The lender will be required to justify the "business necessity" for the policy.
>
> **Example:** In the past, lenders primarily considered net income in making underwriting decisions. In recent years, the trend has been to consider gross income. A lender decided to switch its practices to consider gross income rather than net income. However, in calculating gross income, the lender did not distinguish between taxable and nontaxable income even though nontaxable income is of more value than the equivalent amount of taxable income. The lender's policy may have a disparate impact on individuals with disabilities and the elderly, both of whom are more likely than the general applicant pool to receive substantial nontaxable income. The lender's policy is likely to be proven discriminatory. First, the lender is unlikely to be able to show that the policy is compelled by business necessity. Second, even if the lender could show business necessity, the lender could achieve the same purpose with less discriminatory effect by "grossing up" nontaxable income (i.e., making it equivalent to gross taxable income by using formulas related to the applicant's tax bracket).

Lenders will not have to justify every requirement and practice every time that they face a compliance examination. The Agencies recognize the relevance to credit decisions of factors related to the adequacy of the borrower's income to carry the loan, the likely continuation of that income, the adequacy of the collateral to secure the loan, the borrower's past performance in paying obligations, the availability of funds to close, and the existence of adequate reserves. While lenders should think critically about whether widespread, familiar requirements and practices have an unjustifiable disparate impact, they should look especially carefully at requirements that are more stringent than customary. Lenders should also stay informed of developments in underwriting and portfolio performance evaluation so that they are well positioned to consider all options by which their business objectives can be achieved.

C. Answers to Questions Often Asked by Financial Institutions and the Public

Lending institutions and others often ask the Agencies questions about various aspects of lending discrimination. The Agencies have compiled this list of common questions, with answers, in order to provide further guidance.

Q1: Are disparities in application, approval, or denial rates revealed by Home Mortgage Disclosure Act ("HMDA") data sufficient to establish lending discrimination?

A: HMDA data alone do not prove lending discrimination. The data do not contain enough information on major credit-related factors, such as employment and credit histories, to prove discrimination. Despite these limitations, the data can provide "red flags" that there may be problems at particular institutions. Therefore, regulatory and enforcement agencies may use HMDA data, along with other factors, to identify institutions whose lending practices warrant more scrutiny. Furthermore, HMDA data can be relevant, in conjunction with other data and information, to determine whether a lender has discriminated.

Q2: Does a lending institution that submits inaccurate HMDA data violate lending discrimination laws?

A: An inaccurate HMDA data submission constitutes a violation of the HMDA, the Federal Reserve Board's Regulation C, and other applicable laws, and may subject the lending institution to an enforcement action, which could include civil money penalties, and, if the lender is a HUD-approved mortgagee, the sanctions of the HUD Mortgagee Review Board. An inaccurate HMDA data submission, however, is not in itself a violation of the ECOA or the FH Act. However, a person who intentionally submits incorrect or incomplete HMDA data in order to cover up a violation of the FH Act may be subject, under the FH Act and federal criminal statutes, to a fine or prison term or both. In addition, a failure to ensure accurate HMDA data may be considered as a relevant fact during a FH Act investigation or an examination of the institution's lending activities.

Q3: Does a second review program only for loan applicants who are members of a protected class violate laws prohibiting discrimination in lending?

A: Such programs are permissible if they do no more than ensure that lending standards are applied fairly and uniformly to all applicants. For example, it is permissible to review the proposed denial of applicants who are members of a protected class by comparing their applications to the approved applications of similarly qualified individuals who are not members of a protected class to determine if the applications were evaluated consistently. It is impermissible, however, to review the applications

of members of a protected class in order to apply standards to those applications different from the standards used to evaluate other applications for the same credit program or to apply the same standards in a different manner, unless such actions are otherwise permitted by law, as described in Question 4.

Other types of second review programs are also permissible. For example, lenders could review the proposed denial of all applicants within a certain income range. Lenders also could review a sampling of all applications proposed for denial, or even review all such applications.

Q4: May a lender apply different lending standards to applicants who are members of a protected class in order to increase lending to that sector of its community?

A: Generally, a lender that applies different lending standards or offers different levels of assistance on a prohibited basis, regardless of its motivation, would be violating both the FH Act and the ECOA. There are exceptions to the general rule; thus, applying different lending standards or offering different levels of assistance to applicants who are members of a protected class is permissible in some circumstances. For example, the FH Act requires lenders to provide reasonable accommodation to people with disabilities. In addition, providing different treatment to applicants to address past discrimination would be permissible if done in response to a court order or otherwise in accord with applicable legal precedent. However, the law in this area is complex and developing. Before implementing programs of this sort, a lender should seek legal advice.

Of course, affirmative advertising and marketing efforts that do not involve application of different lending standards are permissible under both the ECOA and the FH Act. For example, special outreach to a minority community would be permissible.

Q5: Should a lender engage in self-testing?

A: Principles of sound lending dictate that adequate policies and procedures be in place to ensure safe and sound lending practices and compliance with applicable laws and regulations, and that a lender adopt appropriate audit and control systems to determine whether the institution's policies and procedures are functioning adequately. This is as true in the area of fair lending as in other operations. Lenders should employ reliable measures for auditing fair lending compliance. A well-designed and implemented program of self-testing could be a valuable part of this process. Lenders should be aware, however, that data documenting lending discrimination discovered in a self-test generally will not be shielded from disclosure.

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Corrective actions should always be taken by any lender that discovers discrimination. Self-testing and corrective actions do not expunge or extinguish legal liability for the violations of law, insulate a lender from private suits, or eliminate the primary regulatory agency's obligation to make the referrals required by law. However, they will be considered as a substantial mitigating factor by the primary regulatory agencies when contemplating possible enforcement actions. In addition, HUD and DOJ will consider as a substantial mitigating factor an institution's self-identification and self-correction when determining whether they will seek additional penalties or other relief under the FH Act and the ECOA. The Agencies strongly encourage self-testing and will consider further steps that might be taken to provide greater incentives for institutions to undertake self-assessment and self-correction.

Q6: **What should a lender do if self-testing evidences lending discrimination?**

A: If a lender discovers discriminatory practices, it should make all reasonable efforts to determine the full extent of the discrimination and its cause, e.g., determine whether the practices were grounded in defective policies, poor implementation or control of those policies, or isolated to a particular area of the lender's operations. The lender should take all appropriate corrective actions to address the discrimination, including, but not limited to:

- Identifying customers whose applications may have been inappropriately processed, offering to extend credit if they were improperly denied; and compensating them for any damages, both out-of-pocket and compensatory; and notifying them of their legal rights;

- Correcting any institutional policies or procedures that may have contributed to the discrimination;

- Identifying, and then training and/or disciplining, the employees involved;

- Considering the need for community outreach programs and/or changes in marketing strategy or loan products to better serve minority segments of the lender's market; and

- Improving audit and oversight systems in order to ensure there is no recurrence of the discrimination.

An institution is not required to report to the Agencies a lending discrimination problem it has discovered. However, a lender that reports its discovery can ensure that the corrective actions it develops are appropriate and complete and thereby minimize the damages to which it will be subject.

Q7: Will a lender be held responsible for discriminatory lending engaged in by a single loan officer where the lending institution has good policies and procedures in place, is otherwise in full compliance with all applicable laws and regulations and neither knows or reasonably could have known that the officer was engaged in illegal discriminatory conduct?

A: Fair lending violations can occur even in the most well-run lending institutions that have good policies in place to ensure compliance with fair lending laws and regulations. Of course, the chances that such violations will occur can be greatly reduced by backing up those policies with proper employee training and supervision and subjecting the lending process to proven systems of oversight and review. Self-testing can further reduce the likelihood that violations may occur. Notwithstanding these efforts, a single loan officer might still improperly apply policies or, worse yet, deliberately circumvent them and manage to conceal or disguise the true nature of his or her practices for a time. It may be particularly difficult to discover this type of behavior when it occurs in the pre-application process.

In any case where discriminatory lending by a lending institution is identified, the lender will be expected to identify and fairly compensate victims of discriminatory conduct just as it would be expected to compensate a customer if an employee's conduct resulted in physical injury to the customer. In addition, such a violation might constitute a "pattern or practice" that must be referred to DOJ or a violation that must be referred to HUD.

As in other cases of discriminatory behavior, where a lender takes self-initiated corrective actions, such actions will be considered as a substantial mitigating factor by the Agencies in determining the nature of any enforcement action and what penalties or other relief would be appropriate.

Q8: If a federal financial institutions regulatory agency has "reason to believe" that a lender has engaged in a pattern or practice of discrimination in violation of the ECOA, the ECOA requires the agency to refer the matter to DOJ. What constitutes a "reason to believe"?

A: A federal financial institutions regulatory agency has reason to believe that an ECOA violation has occurred when a reasonable person would conclude from an examination of all credible information available that discrimination has occurred. This determination requires weighing the available evidence and applicable law and determining whether an apparent violation has occurred. Information supporting a reason to believe finding may include loan files and other documents, credible observations by persons with direct knowledge, statistical analysis, and the financial institution's response to the preliminary examination findings.

Reason to believe is more than an unfounded suspicion. While the evidence of discrimination need not be definitive and need not include evidence of overt discrimination, it should be developed to the point that a reasonable person would conclude that a violation exists.

Q9: **If a federal financial institutions regulatory agency has reason to believe that a lender has engaged in a "pattern or practice" of discrimination in violation of the ECOA, the agency will refer the matter to DOJ. What constitutes a "pattern or practice" of lending discrimination?**

A: Determinations by federal financial institutions regulatory agencies regarding a pattern or practice of lending discrimination must be based on an analysis of the facts in a given case. Isolated, unrelated or accidental occurrences will not constitute a pattern or practice. However, repeated, intentional, regular, usual, deliberate, or institutionalized practices will almost always constitute a pattern or practice. The totality of the circumstances must be considered when assessing whether a pattern or practice is present. Considerations include, but are not limited to:

- Whether the conduct appears to be grounded in a written or unwritten policy or established practice that is discriminatory in purpose or effect;

- Whether there is evidence of similar conduct by a financial institution toward more than one applicant. Note, however, that this is not a mathematical process, e.g., "more than one" does not necessarily constitute a pattern or practice;

- Whether the conduct has some common source or cause within the financial institution's control;

- The relationship of the instances of conduct to one another (e.g., whether they all occurred in the same area of the financial institution's operations); and

- The relationship of the number of instances of conduct to the financial institution's total lending activity. Note, however, that, depending on the circumstances, violations that involve only a small percentage of an institution's total lending activity could constitute a pattern or practice.

Depending on the egregiousness of the facts and circumstances involved, singly or in combination, these factors could provide evidence of a pattern or practice.

Q10: **How does the employment of few minorities and individuals from other protected classes in lending positions -- e.g., Account Executive, Underwriter, Loan Counselor, Loan Processor, Staff Appraiser, Assistant Branch Manager and Branch Manager -- affect compliance with lending discrimination laws?**

A: The employment of few minorities and others in protected classes, in itself, is not a violation of the FH Act or the ECOA. However, employment of few members of protected classes in lending positions can contribute to a climate in which lending discrimination could occur by affecting the delivery of services.

Therefore, lenders might consider the following steps, as appropriate to their institutions:

- Advertising lending job openings in local minority-oriented publications;
- Notifying predominantly minority organizations of such openings;
- Seeking employment referrals from current minority employees, minority real estate boards and local historically minority colleges and other institutions that serve minority groups in the community; and
- Seeking qualified independent fee appraisers from local minority appraisal organizations.

Similar outreach steps could be considered to recruit women, persons with disabilities, and other persons protected by the FH Act and the ECOA.

Q11: What is the role of the guidelines of secondary market purchasers and private and governmental loan insurers in determining whether primary lenders practice lending discrimination?

A: Many lenders make mortgage loans only when they can be sold on the secondary market, or they may place some loans in their own portfolios and sell others on the secondary market. The principal secondary market purchasers, Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("Freddie Mac"), publish underwriting guidelines to inform primary lenders of the conditions under which they will buy loans. For example, ability to repay the loan is measured by suggested ratios of monthly housing expense to income (28%) and total obligations to income (36%). However, these guidelines allow considerable discretion on the part of the primary lender. In addition, the secondary market guidelines have in some cases been made more flexible, for example, with respect to factors such as stability of income (rather than stability of employment) and use of nontraditional ways of establishing good credit and ability to pay (e.g., use of past rent and utility payment records). Lenders should ensure that their loan processors and underwriters are aware of the provisions of the secondary market guidelines that provide various alternative and flexible means by which applicants may demonstrate their ability and willingness to repay their loans. Fannie Mae and Freddie Mac not infrequently purchase mortgages exceeding the suggested ratios, and their guidelines contain

detailed discussions of the compensating factors that can justify higher ratios (and which must be documented by the primary lender).

A lender who rejects an application from an applicant who is a member of a protected class and who has ratios above those of the guidelines and approves an application from another applicant with similar ratios should be prepared to show that the reason for the rejection was based on factors that are applied consistently without regard to any of the prohibited factors.

These same principles apply equally to the guidelines of private and governmental loan insurers.

Q12: What criteria will be employed in taking enforcement actions or seeking remedial measures when lending discrimination is discovered?

A: Enforcement sanctions and remedial measures for lending discrimination violations vary depending on whether such sanctions are sought by the appropriate federal financial institutions regulatory agencies, DOJ, HUD or other federal agencies charged with enforcing either the ECOA or the FH Act. The following discussion sets out the criteria typically employed by the federal banking agencies (i.e., OCC, OTS, the Board and FDIC), NCUA, DOJ, HUD, OFHEO, FHFB and FTC in determining the nature and severity of sanctions that may be used to address discriminatory lending practices. As discussed in Questions 8 and 9, above, in certain situations, the primary regulatory agencies will also refer enforcement matters to HUD or DOJ.

The federal banking agencies:

The federal banking agencies are authorized to use the full range of their enforcement authority under 12 U.S.C. § 1818 to address discriminatory lending practices. This includes the authority to seek:

- Enforcement actions that may require both prospective and retrospective relief; and

- Civil money penalties ("CMPs") in varying amounts against the financial institution or any institution-affiliated party ("IAP") within the meaning of 12 U.S.C. § 1813(u), depending, among other things, on the nature of the violation and the degree of culpability.

In addition to the above actions, the federal banking agencies may also take removal and prohibition actions against any IAP where the statutory requirements for such actions are met.

The federal banking agencies will make determinations as to the appropriateness of any potential enforcement action after giving full consideration to a variety of factors. In making these determinations, the banking agencies will take into account:

- The number and duration of violations identified;
- The nature of the evidence of discrimination (i.e., overt discrimination, disparate treatment or disparate impact);
- Whether the discrimination was limited to a particular office or unit of the financial institution or was more pervasive in nature;
- The presence and effectiveness of any anti-discrimination policies;
- Any history of discriminatory conduct; and
- Any corrective measures implemented or proposed by the financial institution.

The severity of the federal banking agencies' enforcement response will depend on the egregiousness of the financial institution's conduct. Voluntary identification and correction of violations disclosed through a self-testing program will be a substantial mitigating factor in considering whether to initiate an enforcement action.

In addition, the federal banking agencies may consider whether an institution has provided victims of discrimination with all the relief available to them under applicable civil rights laws.

The federal banking agencies may seek both prospective and retrospective relief for fair lending violations.

Prospective relief may include requiring the financial institution to:

- Adopt corrective policies and procedures and correct any financial institution policies or procedures that may have contributed to the discrimination;
- Train financial institution employees involved;
- Establish community outreach programs and changing marketing strategy or loan products to better serve all sectors of the financial institution's service area;
- Improve internal audit controls and oversight systems in order to ensure there is no recurrence of discrimination; or
- Monitor compliance and provide periodic reports to the primary federal regulator.

Retrospective relief may include:

- Identifying customers who may have been subject to discrimination and offering to extend credit if the customers were improperly denied;

- Requiring the financial institution to make payments to injured parties:

  - Restitution: This may include any out-of-pocket expenses incurred as a result of the violation to make the victim of discrimination whole, such as: fees or expenses in connection with the application; the difference between any greater fees or expenses of another loan granted elsewhere after denial by the discriminating lender; and, when loans were granted on disparate terms, appropriate modification of those terms and refunds of any greater amounts paid.

  - Other Affirmative Action As Appropriate to Correct Conditions Resulting From Discrimination: The federal banking agencies also have the authority to require a financial institution to take affirmative action to correct or remedy any conditions resulting from any violation or practice. The banking agencies will determine whether such affirmative action is appropriate in a given case and, if such action is appropriate, the type of remedy to order.

- Requiring the financial institution to pay CMPs:

  The banking agencies have the authority to assess CMPs against financial institutions or individuals for violating fair lending laws or regulations. Each agency has the authority to assess CMPs of up to $5,000 per day for any violation of law, rule or regulation. Penalties of up to $25,000 per day are also permitted, but only if the violations represent a pattern of misconduct, cause more than minimal loss to the financial institution, or result in gain or benefit to the party involved. CMPs are paid to the U.S. Treasury and therefore do not compensate victims of discrimination.

National Credit Union Administration:

For federally insured credit unions, NCUA will employ criteria comparable to those of the other federal financial institutions regulatory agencies, pursuant to its authority under 12 U.S.C. § 1786.

The Department of Justice:

The Department of Justice is authorized to use the full range of its enforcement authority under the Fair Housing Act, 42 U.S.C. § 3601 et seq., and the Equal Credit Opportunity Act, 15 U.S.C. § 1691 et seq. DOJ has authority to commence pattern

or practice investigations of possible lending discrimination on its own initiative or through referrals from the federal financial institutions regulatory agencies, and to file lawsuits in federal court where there is reasonable cause to believe that such violations have occurred. DOJ is also authorized under the FH Act to bring suit based on individual complaints filed with HUD where one of the parties to the complaint elects to have the case heard in federal court.

The relief sought by DOJ in lending discrimination lawsuits may include:

- An injunction which may require both prospective and retrospective relief; and,

- In enforcement actions under the FH Act, CMPs not to exceed $50,000 per defendant for a first violation and $100,000 for any subsequent violation.

Prospective injunctive relief may include:

- A permanent injunction to insure against a recurrence of the unlawful practices;

- Affirmative measures to correct past discriminatory policies, procedures, or practices, so long as consistent with safety and soundness, such as:

    - Expansion of the lender's service areas to include previously excluded minority neighborhoods;

    - Opening branches or other credit facilities in under-served minority neighborhoods;

    - Targeted sales calls on real estate agents and builders active in minority neighborhoods;

    - Advertising through minority-oriented media;

    - Self-testing;

    - Employee training;

    - Changes to commission structures which tend to discourage lending in minority and low-income neighborhoods; and

    - Changes in loan processing and underwriting procedures (including second reviews of denied applications) to ensure equal treatment without regard to prohibited factors; and

- Record keeping and reporting requirements to monitor compliance with remedial obligations.

Retrospective injunctive relief may include relief for victims of past discrimination, actual and punitive damages, and offers or adjustments of credit or other forms of loan commitments.

The Department of Housing and Urban Development:

The Department of Housing and Urban Development is fully authorized to investigate complaints alleging discrimination in lending in violation of the FH Act and has the authority to initiate complaints and investigations even when an individual complaint has not been received. HUD issues determinations on whether or not reasonable cause exists to believe that the FH Act has been violated. HUD also may authorize actions for temporary and preliminary injunctions to be brought by DOJ and has authority to issue enforceable subpoenas for information related to investigations.

Following issuance of a determination of reasonable cause under the FH Act, HUD enforces the FH Act administratively unless one of the parties elects to have the case heard in federal court in a case brought by DOJ.

Relief under the FH Act that may be awarded by an administrative law judge ("ALJ") after a hearing, or by the Secretary on review of a decision by an ALJ, includes:

- Injunctive or other appropriate relief, including a variety of actions designed to correct discriminatory practices, such as changes in loan processes or procedures, modifications of loan service areas or branching actions, approval of previously denied loans to aggrieved persons, additional record-keeping and reporting on future activities or other affirmative relief;

- Actual damages suffered by persons who are aggrieved by any violation of the FH Act, including damages for mental distress and out-of-pocket losses attributable to a violation; and

- Civil penalties of up to $10,000 for each initial violation and up to $25,000 and $50,000 for successive violations within specific time frames.

HUD also is authorized to direct Fannie Mae and Freddie Mac to undertake various remedial actions, including suspension, probation, reprimand, or settlement, against lenders found to have engaged in discriminatory lending practices in violation of the FH Act or the ECOA.

The Office of Federal Housing Enterprise Oversight:

The Office of Federal Housing Enterprise Oversight is authorized to use its enforcement authority under 12 U.S.C. §§ 4631 and 4636, including cease and desist orders and CMPs for violations by Fannie Mae and Freddie Mac of the fair housing regulations promulgated by the Secretary of HUD pursuant to 12 U.S.C. § 4545.

The Federal Housing Finance Board:

While the Federal Housing Finance Board does not have enforcement authority under the ECOA or the FH Act, in reviewing the members of the Federal Home Loan Bank System for community support, it may restrict access to long-term System advances to any member that within two years prior to the due date of submission of a Community Support Statement, had a final administrative or judicial ruling against it based on violations of those statutes (or any similar state or local law prohibiting discrimination in lending). System members in this situation are asked to submit to the Finance Board an explanation of steps taken to remedy the violation or prevent a recurrence.

The Federal Trade Commission:

The Federal Trade Commission enforces the requirements of the ECOA and Regulation B for all lenders subject to the ECOA, except where enforcement is specifically committed to another agency. The FTC may exercise all of its functions and powers under the Federal Trade Commission Act ("FTC Act") to enforce the ECOA, and a violation of any requirement under the ECOA is deemed to be a violation of a requirement under the FTC Act. The FTC has the power to enforce Regulation B in the same manner as if a violation of Regulation B were a violation of an FTC trade regulation rule.

This means that the FTC has the power to investigate lenders suspected of lending discrimination and to use compulsory process in doing so. The Commission, through DOJ or on its own behalf where the Justice Department declines to act, may file suit in federal court against suspected violators and seek relief including:

- Injunctions against the violative practice;
- Civil penalties of up to $10,000 for each violation; and
- Redress to affected consumers.

In addition, the Commission routinely imposes recordkeeping and reporting requirements to monitor compliance.

Q13: Will a financial institution be subjected to multiple actions by DOJ or HUD and its primary regulator if discriminatory practices are discovered?

A: In all cases where referrals to other agencies are made, the appropriate federal financial institutions regulatory agency will engage in ongoing consultations with DOJ or HUD regarding coordination of each agency's actions. The Agencies will coordinate their enforcement actions and make every effort to eliminate unnecessarily duplicative actions. Where both a federal financial institutions regulatory agency and either DOJ or HUD are contemplating taking actions under their own respective authorities, the Agencies will seek to coordinate their actions to ensure that each agency's action is consistent and complementary. The financial institutions regulatory agencies also will discuss referrals on a case-by-case basis with DOJ or HUD to determine whether multiple actions are necessary and appropriate.

U. S. Department of Housing and Urban Development
Washington D C 20410-4000

OFFICE OF THE ASSISTANT SECRETARY
FOR PUBLIC AFFAIRS

FAIR LENDING FACT SHEET

The statement issued today addresses lending discrimination as prohibited by the Fair Housing Act and the Equal Credit Opportunity Act. In addition to those two laws, there is the Home Mortgage Disclosure Act and the Community Reinvestment Act, which address fair access to credit and capital.

Following is a thumbnail sketch of these laws:

- The **Fair Housing Act** prohibits discrimination in housing, based on race, color, religion, sex, national origin, handicap, or family status. The law covers the rental, sale and improvement of housing, as well as discrimination in advertising, and zoning and land use decisions. The law was originally enacted in 1968.

- Under the **Equal Credit Opportunity Act,** it is unlawful for lenders to discriminate in any aspect of a credit transaction. Prohibited factors include race or color, national origin, religion, sex, marital status and age. Mortgage loans, consumer loans, extensions of credit to small businesses, corporations, partnerships and trusts are covered under this law.

- The **Home Mortgage Disclosure Act** was originally enacted in 1975 to prevent lending discrimination and "redlining" by requiring public disclosure of certain information about mortgage loan applications. HMDA data alone does not contain enough information about applicants (such as employment and credit histories) to prove lending discrimination, but the data can provide "red flags" about problems at particular institutions.

- The **Community Reinvestment Act** was originally enacted in 1977, and seeks to encourage lending institutions to meet the credit needs of the entire communities they serve. The goals of the law are to generate loans and consumer banking services in depressed communities.

DEPARTMENT OF JUSTICE FACT SHEET

Lending Laws Enforced by the Justice Department

- **The Fair Housing Act** prohibits discrimination based on race, color, national origin, religion, sex, handicap and familial status (families with children) in all residential real estate-related transactions. Those transactions include making loans to buy, build, repair or improve a dwelling; purchasing real estate loans; selling, brokering or appraising residential real estate; and the selling or renting of a dwelling.

- **The Equal Credit Opportunity Act** prohibits discrimination based on race, color, national origin, religion, sex, marital status and age, among others, in any credit transaction. It applies not only to housing-related loans, but to loans for small businesses, corporations, partnerships, and trusts.

Increase in Civil Rights Division Resources

- The Attorney General recently added 18 new positions to the Housing Section of the Civil Rights Division that combats housing and lending discrimination -- increasing the staff by nearly one third. The Attorney General also has asked United States Attorneys to handle some housing discrimination cases so that the Housing Section can devote more resources to discrimination in lending.

Investigations Currently Underway

- The Civil Rights Division is currently investigating the lending practices of several financial institutions, including major lenders in Chicago and Miami. It also is reviewing cases of possible discriminatory lending practices that it was referred by other federal financial regulators.

Actions Taken by the Justice Department

- US v. First National Bank of Vicksburg (Mississippi); Filed complaint January 1994, alleging that lender discriminated against blacks seeking unsecured home improvement loans by charging them 4 to 11% higher interest rates than it charged to whites. Under a consent decree filed simultaneously with the complaint, lender agreed to conduct second reviews of applications, train its officers in fair lending, and pay about $4,400 each to 170 black borrowers who were victims of Vicksburg's alleged discriminatory policies.

- US v. Blackpipe State Bank (South Dakota); Filed complaint November 1993, alleging that lender discriminated against Native Americans by refusing to make loans secured by collateral located on reservations and by charging Native Americans greater interest rates and finance charges than those charged to whites. Under a consent decree filed January 1994, lender agreed to expand its services to reservations, market its products to Native Americans, reduce interest rates and finance charges on existing discriminatory loans, and create a $125,000 compensation fund for past rejected applicants who may be eligible for compensation.

- US v. Shawmut Mortgage Company (Connecticut); Filed complaint December 1993, alleging that lender discriminated against black and Hispanic applicants for home mortgage loans by failing to provide them with the same level of assistance it provided to white applicants and by applying more stringent underwriting standards to them than were applied to whites. Under a consent decree filed simultaneous with the complaint, lender agreed to create an initial $960,000 compensation fund from which victims of discrimination will be paid between $10,000 and $15,000. Lender also agreed to continue implementing corrective measures it had begun over a year earlier, including training officers in fair lending, conducting random testing to ensure employees are not discouraging minorities from applying for loans, and extending advertising and marketing to reach minority communities.

- US v. Decatur Federal Savings and Loan (Georgia); Filed complaint September 1992, alleging that lender discriminated against blacks by applying stricter underwriting standards to black applicants and by marketing, advertising, and conducting branching activities in a way as to avoid dealing with black applicants. Under consent decree filed simultaneously with the complaint, lender agreed to implement a variety of corrective measures and pay $1 million in compensatory and punitive damages to 48 black applicants identified as victims of discrimination.

THE FEDERAL RESERVE'S ROLE IN ENFORCEMENT OF THE LENDING DISCRIMINATION LAWS

The Board of Governors of the Federal Reserve System has a primary role in many aspects of the federal government's efforts to combat lending discrimination through its sole responsibility for implementing two major fair lending laws and its enforcement, examination and educational programs.

- The Federal Reserve is the regulatory agency with sole responsibility for writing regulations for, and interpreting, the Equal Credit Opportunity Act (ECOA) and the Home Mortgage Disclosure Act (HMDA). ECOA is the broadest lending discrimination statute enacted into law -- extending to all forms of lending, including mortgages and other consumer and business credit. HMDA requires the collection of extensive information about applicants for mortgages and home improvement loans. As such, it is significant in helping to detect lending discrimination and the enforcement of the ECOA and Fair Housing Act.
- The Board has had a specialized consumer compliance examination program since 1977, and has staff specialists devoted to compliance and regulatory issues concerning fair lending. Further, the 12 regional Federal Reserve Banks maintain an examination program to ensure compliance with the fair lending laws -- on-site examinations are conducted approximately every 18 months. For years, Federal Reserve examiners have conducted detailed investigations -- loan file by loan file -- into possible lending discrimination by comparing applicants who were denied credit with those who were granted credit to ensure that credit decisions have been made on a nondiscriminatory basis. The examiners have enhanced their investigative ability through the use of a sophisticated statistical model for analyzing information drawn from HMDA data and loan files. In addition, the Federal Reserve System conducts an extensive educational program for its examiners in all areas of compliance and will soon institute an extensive specialized training for fair lending investigations. Finally, our community affairs and consumer complaint investigation programs are also important elements of fair lending enforcement by the Federal Reserve.
- The Federal Reserve System has been instrumental in furthering agency detection and enforcement of the fair lending laws in other ways, such as through the significant study of lending discrimination conducted by the Federal Reserve Bank of Boston. The study was initiated to evaluate the differences in the rates of home loan denials shown in the 1990 HMDA data. In response to the Boston Reserve Bank study, the Federal Reserve and the other financial regulatory agencies issued a joint statement alerting lenders to the extent of the problem underlying the statistics and stressing the need for them to intensify their efforts to avoid discrimination in their own lending programs.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

March 8, 1994

OFFICE OF THE COMPTROLLER OF THE CURRENCY

The Office of the Comptroller of the Currency (OCC) was established in 1863 as a bureau of the Department of Treasury. The OCC is headed by Comptroller Eugene A. Ludwig, who was appointed in 1993 to a 5-year term by the President, with the advice and consent of the Senate.

The OCC, as regulator and supervisor of the national banking system, regularly examines the country's approximately 3400 national banks to ensure safety and soundness and compliance with all applicable laws and regulations, including the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act.

The OCC takes enforcement actions against national banks that do not conform to laws and regulations or which engage in unsound banking practices, and as appropriate, refers cases involving violations of fair lending laws to the Department of Justice (DOJ) or the Department of Housing and Urban Development (HUD). The OCC, under 12 U.S.C. §1818, has authority to impose enforcement sanctions and require remedial measures to address discriminatory lending practices.

In addition to participation on the Interagency Task Force on Fair Lending, OCC fair lending initiatives include:

> Fair Lending Examination Procedures
>
> New examination procedures adopted in May 1993 are designed to detect discrimination in national banks' residential lending activities. Fair lending examination procedures are used in all banks reporting at least five mortgage loan denials in any given year for either blacks, Hispanics or Native Americans, and can also be adapted to detect other forms of lending discrimination.

-more-

First National Bank of Vicksburg, Vicksburg, Mississippi

As the result of violations of fair lending laws that led to a pattern of discrimination against black borrowers, the OCC, jointly with the DOJ, agreed to a settlement that required the bank to set aside $750,000 to compensate the victims and to pay a $50,000 penalty. The settlement also required the bank to make at least $1 million in loans available to low- and moderate-income borrowers; to establish a customer assistance program; to adopt and implement a new fair lending policy and loan review system; to initiate a self-testing program; and to train its officers, directors and credit employees about the purpose of and prohibitions in the fair lending laws.

Referrals to the DOJ and HUD

In addition to the Vicksburg case, the OCC made 3 referrals to DOJ in 1993, and notified HUD of isolated fair lending violations in 2 cases. Other cases currently under review by the OCC may lead to referrals later this year.

Pilot Testing Program

The OCC is working to establish a matched pair testing program to detect discrimination in the pre-application stage of the credit process.

Increased Staffing and Resources

The OCC has increased its used of specialist examiners to conduct fair lending and other consumer compliance examinations, and has adopted expanded training and career development for them. The agency has also hired two specialists experienced in civil rights enforcement to develop, implement and monitor the OCC's fair lending program and support examiner efforts to detect discrimination.

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Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6000

March 7, 1994

OTS FAIR LENDING FACT SHEET

Policy: OTS policy with regard to fair lending mirrors the Interagency Task Force on Fair Lending policy statement. Discrimination on a prohibited basis is intolerable and socially and economically destructive. An essential part of the OTS mission is to ensure that the savings associations it regulates treat loan applicants fairly and consistently under the law.

History: The agency established a specialized compliance examination program in 1989. Under this program, compliance examinations are conducted by specially trained and career-professional examiners in the five OTS regional offices. OTS now has approximately 100 compliance examiners. Fair lending laws and regulations are reviewed as part of compliance examinations along with consumer protection laws, Community Reinvestment Act and the Bank Secrecy Act.

In late 1992, the agency began a review of fair lending activities with the goal of improving performance. Out of this review, OTS developed a three-part plan to combat lending discrimination in the thrift industry, involving:

1. Improved discrimination detection techniques used by examiners;
2. Strengthened enforcement response by ensuring that appropriate referrals are made to Justice and HUD and that formal enforcement actions are taken to address noncompliance where warranted; and
3. Working with the industry and other interested groups to create a better sense of awareness about discrimination through education as a means of preventing it.

Action: OTS has taken the following steps so far in implementing its plan:

1. Made five referrals in past 12 months to Justice for violations of Equal Credit Opportunity Act;
2. Cooperated in the development of interagency policy statement issued today.
3. Held a series of meetings with various community organizations to discuss consumer and fair lending issues;
4. With the other banking agencies, will hold this year education seminars on discrimination for the chief executives of banks and thrifts; and
5. Will expand and improve its own compliance training curricula, and work with other regulators to develop an advanced training school.

FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20429

Corporate Communications Office

FDIC DETAILS 1993 FAIR LENDING ENFORCEMENT EFFORTS

The Federal Deposit Insurance Corporation (FDIC) supervises approximately 7,200 financial institutions, including savings banks. FDIC-supervised institutions are state chartered financial institutions that are not members of the Federal Reserve System. To enforce compliance with fair lending laws, the FDIC undertakes two primary activities: bank examinations and complaint investigations. The FDIC conducted 3,537 consumer compliance examinations during calendar year 1993. It also responded to over 5,700 written complaints and inquiries, of which 857 concerned the Equal Credit Opportunity Act (ECOA) and 662 concerned the Fair Housing Act (FHA).

The Division of Supervision (DOS) and the Office of Consumer Affairs (OCA) oversee the FDIC's Compliance Program. DOS examines for fair lending compliance through its compliance examination program. The FDIC has significantly strengthened its compliance enforcement, particularly in the complex areas of ECOA and FHA, through the use of specialized compliance examiners. At the end of 1993, there were 266 field compliance examiner positions with 32 regional office review examiner positions in the program.

The OCA, an independent office reporting directly to the Office of the Chairman, has oversight responsibility for the FDIC compliance examination program and consumer complaint investigations. The OCA also administers the Community Affairs Program (CAP) whose staff does community outreach activity in order to promote enhanced compliance with fair lending laws and regulations by FDIC-supervised institutions.

In 1993, the FDIC participated with the Department of Justice (DOJ) on items that were included in DOJ's consent agreement with the Blackpipe State Bank, an FDIC-supervised institution in Martin, South Dakota. DOJ alleged that the bank had engaged in lending

practices that discriminated against Native Americans through its explicit policy of refusing to make a loan secured by collateral that might be subject to tribal court jurisdiction. DOJ also alleged that the bank charged a higher interest rate to Native Americans and had placed credit requirements on tribal members that it did require of whites -- a violation of ECOA and FHA. In its settlement with DOJ, the bank agreed to engage in certain affirmative lending practices to address potentially discriminatory practices and to set aside $125,000 in a fund to reimburse injured parties.

March 8, 1994

Federal
Housing
Finance
Board

NEWS

1777 F Street, N.W., Washington, D.C. 20006
(202) 408-2986

THE FEDERAL HOUSING FINANCE BOARD

- The Federal Housing Finance Board (Finance Board) was established as an independent agency in the Executive Branch by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989.

- The Finance Board has supervisory authority and oversight responsibility for the twelve Federal Home Loan Banks and the Office of Finance. The Finance Board ensures the safety and soundness of the Bank System, administers the Affordable Housing, Community Investment, and Community Support Programs and oversees the FHLBanks' financial performance and operations.

- The Finance Board consists of a five-director board -- one of whom is the Secretary of Housing & Urban Development. The other four directors are appointed by the President and are subject to Senate confirmation. One of the directors is a "consumer/community" director. The current Finance Board directors are:

  Secretary Henry G. Cisneros*
  Board Director, vacant as of 1/1/94 (2000)
  Board Director, vacant as of 11/22/93 (1999)
  Board Director, vacant as of 1/1/94 (1997)
  Lawrence U. Costiglio of New York (1992-1995)

  *Secretary Cisneros has designated Assistant Secretary for Housing - Federal Housing Commissioner, Nicolas P. Retsinas, to serve in his Board position.

- The Finance Board directors are chosen from among people with extensive experience in housing finance or with a commitment to the provision of specialized housing credit. One director must be chosen from organizations representing consumer or community interests on banking services, credit needs, housing or consumer protection.

- The Finance Board is supported by assessments from the twelve Federal Home Loan Banks. The Banks, in turn, finance their own operations by charging for credit products and services they provide to member institutions. No tax dollars or other appropriations are used to support the operations of the Finance Board or the Bank System.

March 1994

NATIONAL CREDIT UNION ADMINISTRATION

ALEXANDRIA, VA 22314-3428

FACT SHEET

The National Credit Union Administration is an independent Federal agency established by Congress to oversee the federal credit union system. NCUA is funded by credit unions and receives no tax dollars.

Today, NCUA supervises and insures nearly 8,000 federal credit unions and insures member accounts in approximately 4,600 state-chartered credit unions.

The National Credit Union Share Insurance Fund is the arm of the agency that insures member accounts up to $100,000. It is backed by the full faith and credit of the U.S. government and is managed by the NCUA Board. The fund has never had a net loss and, since it was recapitalized in 1985, the equity ratio (the fund balance as a percentage of insured deposits) has remained at or near 1.25 percent.

NCUA has a three-member board appointed by the President of the United States.

Chairman Norman E. D'Amours is a former U.S. Congressman who was practicing law in his home state of New Hampshire when appointed NCUA chairman in November 1993.

Vice Chairman Shirlee P. Bowné is a former real estate broker in Tallahassee and was on the board of the Florida Housing Finance Agency when she was appointed in October 1991.

Member Robert H. Swan is a former president of Tooele Federal Credit Union, Tooele, Utah, and previously served as Utah deputy director of finance. He took office in April 1990.

Credit unions are non-profit cooperatives organized to provide members with financial service. Well over 60 million Americans save and borrow at credit unions. For ten consecutive years, credit unions have ranked number one, by a large margin, in an annual customer satisfaction survey of financial institutions.

Although most credit unions are relatively small, they are safe and sound. Membership, deposits, assets, and loans grow consistently year after year and capital levels are high. The number of troubled credit unions is declining and loan delinquencies are low.

Federal Trade Commission

THE UNITED STATES FEDERAL TRADE COMMISSION

The Federal Trade Commission has the power to investigate certain lenders suspected of lending discrimination and to compel them to produce written documents or oral testimony in the course of such investigations. The FTC's authority arises from the Equal Credit Opportunity Act and its implementing Regulation B, and extends to all lenders subject to ECOA except banks, savings and loan institutions and credit unions, jurisdiction over which is specifically given to other agencies.

The FTC, through the Department of Justice (or on its own behalf if the Justice Department declines to take action), may file suit in federal district court against lenders suspected of violating the law. In so doing, the Commission can seek injunctions against future illegal conduct, civil penalties of up to $10,000 for each violation, and redress for consumers unfairly denied loans. In addition, the FTC routinely imposes record-keeping and reporting requirements on defendants -- these are designed to assist the Commission in monitoring their compliance with orders.

Last December, in its most recent ECOA case, the FTC and the Justice Department together entered into a settlement agreement with Shawmut Mortgage Company. Shawmut agreed to pay almost $1 million into a redress fund to compensate African American and Hispanic applicants who allegedly were unfairly denied mortgage loans from 1990 through late 1992. The agreement establishes a procedure to identify and compensate applicants that the FTC and Justice alleges were illegally discriminated against. It also prohibits Shawmut from discriminating on the basis of race or national origin, in violation of the ECOA or the Fair Housing Act, in the future.

OFHEO

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

March 8, 1994

OFHEO STATEMENT ON FAIR LENDING

The **Office of Federal Housing Enterprise Oversight (OFHEO)**, the federal government's newest financial regulator, is responsible for overseeing the safety and soundness of the nation's two largest housing finance organizations -- the **Federal National Mortgage Association (Fannie Mae)**, and the **Federal Home Loan Mortgage Corporation (Freddie Mac)**.

The legislation creating OFHEO -- the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (P.L. 102-550) -- also gives the Office enforcement authority over violations by Fannie Mae and Freddie Mac in the area of fair lending.

OFHEO's enforcement authority relates to regulations issued by the HUD Secretary that prohibit discrimination by Fannie Mae or Freddie Mac in the purchase of any mortgage, as spelled out in Sec. 1325 of the Act. The remedies available to OFHEO include cease-and-desist orders, and the imposition of civil money penalties.

"There is no inconsistency between fair lending and financial safety and soundness," said **OFHEO Director Aida Alvarez**. "Pulling the government's fair lending rules into one coherent policy is an intelligent and long-overdue action that will help lending institutions make the decisions that are right for America," said Ms. Alvarez.

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OFHEO is an independent office of the Department of Housing and Urban Development. OFHEO reports to Congress, but receives no government funds; it is funded through assessments of Fannie Mae and Freddie Mac. In its safety and soundness mission, OFHE is analogous to such other federal financial regulators as the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Reserve Board.

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effective date of this Order, or later than three months following the effective date of this Order, unless such period is extended for good cause by the Board or the Federal Reserve Bank of Cleveland, acting pursuant to delegated authority.

By order of the Board of Governors, effective March 1, 1993.

Voting for this action: Chairman Greenspan and Governors Mullins, Angell, Kelley, LaWare, Lindsey, and Phillips.

JENNIFER J. JOHNSON
Associate Secretary of the Board

Banc One Corporation
Columbus, Ohio

Order Approving Acquisition of Banks and Certain Nonbanking Companies

Banc One Corporation, Columbus, Ohio ("Banc One"), a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has applied for the Board's approval under section 3 of the BHC Act (12 U.S.C. § 1842) to acquire Valley National Corporation, Phoenix, Arizona ("Valley National"), and thereby indirectly acquire Valley National's subsidiary banks, The Valley National Bank of Arizona, Phoenix, Arizona ("Valley National Bank"), Valley Bank & Trust Company, N.A., Salt Lake City, Utah, Valley Central Bank, Richfield, Utah, and California Valley Bank, N.A., Fresno, California.[1]

Banc One also has applied under section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)) to acquire Concho Insurance Agency, Inc. ("Concho Insurance") and VNC Investment Corporation ("VNC Investment"), both of Phoenix, Arizona, and thereby engage in the sale of credit-related insurance pursuant to 12 C.F.R. 225.25(b)(8)(i), and in the making and arranging of commercial loans pursuant to 12 C.F.R. 225.25(b)(1).

Notice of the applications, affording interested persons an opportunity to submit comments, has been published (57 *Federal Register* 46,170 (1992)). The time for filing comments has expired, and the Board has considered the applications and all comments received in light of the factors set forth in sections 3(c) and 4(c)(8) of the BHC Act.

Banc One, with $51.2 billion in total consolidated assets, is the ninth largest commercial banking organization in the United States, controlling $39.6 billion in deposits.[2] Banc One operates 61 subsidiary banks in Ohio, Indiana, Michigan, Wisconsin, Illinois, Texas, Colorado, and Kentucky. Valley National, with $10.9 billion in total consolidated assets, is the largest commercial banking organization in Arizona, controlling approximately $9 billion in deposits in the state.

Douglas Amendment

Section 3(d) of the BHC Act, the Douglas Amendment, prohibits the Board from approving an application by a bank holding company to acquire control of any bank located outside of the bank holding company's home state, unless such acquisition is "specifically authorized by the statute laws of the State in which such bank is located, by language to that effect and not merely by implication."[3] Banc One proposes to acquire banks in Arizona, Utah, and California. For purposes of the Douglas Amendment, the home state of Banc One is Ohio.[4]

The interstate banking statutes of Arizona and Utah permit out-of-state bank holding companies to acquire banks located in those states, subject only to the approval of state banking officials.[5] The banking authorities of Arizona and Utah have indicated that the proposed transaction is authorized under their respective state laws. Under California law, a foreign bank holding company may acquire a bank located in California, if the Superintendent determines that substantial reciprocity exists between California and the state in which the foreign bank holding company's operations are principally conducted, which in this case is Ohio.[6] Ohio law imposes a similar substantial reci-

1. The proposal is structured as a merger of Banc One's wholly owned subsidiary, Banc One Alpha Corporation, Columbus, Ohio ("Banc One Alpha"), with and into Valley National. Pursuant to the merger, the shares of Valley National will be converted into shares of Banc One, and the shares of Banc One Alpha will be converted into shares of Valley National as the surviving corporation. Banc One Alpha has no assets or operations, and was formed for the purpose of consummating this transaction.

2. Asset and deposit data are as of September 30, 1992.

3. 12 U.S.C. § 1842(d).

4. A bank holding company's home state is that state in which the operations of the bank holding company's banking subsidiaries were principally conducted on July 1, 1966, or the date on which the company became a bank holding company, whichever is later. *See* 12 U.S.C. § 1842(d).

5. *See* Ariz. Rev. Stat. Ann. § 6-322(A); Utah Code Ann. § 7-1-702(2).

6. *See* Cal. Fin. Code § 3751 *et seq.* (West 1993). Substantial reciprocity exists between California and a second state if the laws of the second state:

(i) Authorize a California bank holding company to acquire banks in that state on substantially the same terms and conditions as would be applicable to an acquisition by an in-state bank holding company, and

(ii) Grant to a bank owned by a California bank holding company substantially the same rights and powers as would be granted to a bank owned by an in-state bank holding company. Cal. Fin. Code § 3751(l) (West 1993)

procity requirement.[7] The California Superintendent of Banks has determined that the interstate banking provisions of Ohio law meet the California requirement of substantial reciprocity, and has approved this proposal.

For these reasons, the Board has concluded that Banc One is authorized under the statute laws of Arizona, Utah, and California to acquire the banking subsidiaries of Valley National. Accordingly, Board approval of this proposal is not prohibited by the Douglas Amendment. Approval of this proposal is conditioned, however, upon the receipt by Banc One of all required state regulatory approvals.

Public Comments on Convenience and Needs Considerations

In acting upon an application to acquire a depository institution under the BHC Act, the Board must consider the convenience and needs of the communities to be served, and take into account the records of the relevant depository institutions under the Community Reinvestment Act (12 U.S.C. § 2901 *et seq.*) ("CRA"). The CRA requires the federal financial supervisory agencies to encourage financial institutions to help meet the credit needs of the local communities in which they operate, consistently with the safe and sound operation of such institutions. To accomplish this end, the CRA requires the appropriate federal supervisory authority to "assess the institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution," and to take that record into account in its evaluation of applications.[8]

In connection with these applications, the Board has received comments from approximately 60 organizations and individuals who have expressed their views as to the merits of Banc One's proposal. Of these commenters, approximately half submitted statements supporting the proposal, primarily on the basis of the CRA record of the Banc One organization. These commenters generally praised the CRA efforts of Banc One and its subsidiaries. For example, some of these commenters—focusing on Banc One's efforts in Middletown, Cleveland, Columbus, and Cincinnati, all in Ohio—commended Banc One's minority outreach programs, activities to assist low- and moderate-income residents, financing to small and minority businesses, and lending for low-income housing, among other areas of CRA performance.

Other favorable commenters, including public officials, religious and minority groups, business and social service organizations, community development corporations, and members of the public, commended Banc One's CRA record in Dayton, Ohio. Their comments noted with approval Banc One's efforts in such areas as technical assistance for and investments in community development initiatives; lending programs, including flexible loan products designed to meet the credit needs of low- and moderate-income borrowers; support for small minority businesses; and funding for first-time home buyers. Favorable comments also have been received on various aspects of Banc One's CRA efforts elsewhere in Ohio or in Texas, or with respect to the CRA record of Valley National Bank in Arizona.

Commenters opposing the proposal ("Protestants") have objected on the basis of the CRA performance records of Banc One's and Valley National's subsidiary banks, and have criticized the efforts of Banc One and Valley National to meet the credit needs of their entire communities, including low- and moderate-income neighborhoods.[9] Protestants believe that Valley National Bank has insufficient outreach and marketing programs for low- and moderate-income families and

See also Cal Fin. Code § 3752(a)(4) (West 1993) (providing that the state in which the operations of a U.S bank holding company are principally conducted is the state in which the total deposits of its subsidiary banks are largest)

7. *See* Ohio Rev Code Ann. § 1101.05 (Anderson 1988) (permitting interstate acquisitions if the acquiring company's home state would permit acquisitions of banks in such state by an Ohio-based bank holding company on terms that are substantially no more restrictive than those established for out-of-state bank holding companies under Ohio law) Ohio law also prohibits an acquiring out-of-state institution from controlling more than 20 percent of all financial institution deposits in Ohio upon consummation of the transaction, and requires the bank commissioner to review the financial, managerial, and convenience and needs considerations of the proposed acquisition. *Id.*

8 *See* 12 U.S.C § 2903

9 The Board has received a number of comments from individuals and businesses alleging that the denial of their loan applications by subsidiaries of Banc One or Valley National evidenced a failure to comply with the CRA or fair lending laws Financial information has been provided regarding some of these transactions. The Board believes that the decision whether to grant credit in an individual case rests with the lending institution In making this decision, the Board expects the institution to abide by safe and sound banking practices and to provide equal opportunity for credit to all applicants. After careful consideration of the comments and all the evidence in the record, including relevant examination reports and responses to those comments, the Board has concluded that the comments regarding individual loan denials do not indicate that Banc One or Valley National has engaged in any unsafe or unsound lending practices or has refused to extend credit in violation of the Equal Credit Opportunity Act or other relevant statutes

The Board also has reviewed comments from parties currently or previously involved in litigation or other disputes with Banc One or Valley National, or one of their respective subsidiaries, in connection with bankruptcy or foreclosure proceedings or other matters relating to outstanding loans. In light of all the facts of record, including relevant examination reports, the Board does not believe that these comments warrant denial of these applications. The Board also notes that these commenters will be able to obtain any appropriate relief to their grievances under applicable principles of law.

for minorities, particularly Hispanics and African- and Native-Americans, and insufficient involvement by its board of directors in CRA-related matters and oversight. Protestants also have specifically criticized Valley National Bank's record regarding:

(1) Lending to minority businesses, homeowners, and consumers and to low- and moderate-income neighborhoods and persons in its service communities;

(2) Lending to small businesses, particularly with respect to loan programs supported by the Small Business Administration ("SBA");

(3) Disproportionate rates of denying applications submitted by minority and low- and moderate-income credit applicants as reflected in data reported under the Home Mortgage Disclosure Act ("HMDA"); and

(4) Support for community development projects and programs, and philanthropic contributions relating to the economic and housing needs of inner-city and minority communities.[10]

These criticisms also were reflected in Protestants' comments relating to the CRA performance records of Banc One's subsidiary banks, particularly banks located in Cleveland, Columbus, and Cincinnati, all in Ohio. Several Protestants also criticized the geographic distribution of Banc One's branch offices in Cleveland, and the overall commitment of Banc One's boards of directors and senior management to CRA-related objectives, particularly in the development of special credit products to assist in meeting the credit needs of low- and moderate-income individuals. One Protestant, while acknowledging positive CRA efforts of Banc One in Ohio, expressed concern that this transaction would result in adverse impacts upon, or insufficient benefits for, minority and low- and moderate-income communities similar to deficiencies alleged by this Protestant in connection with Banc One's previous expansion into Texas.[11]

Some Protestants have requested that the Board delay the processing of these applications so that the Board may receive additional information and comment, including loan information from Banc One.[12] Several Protestants also have urged the Board not to act until the results of a pending CRA performance examination of Valley National Bank by the Office of the Comptroller of the Currency ("OCC") have been made available for public comment. Other commenters have requested that the Board conduct audits of the lending records and practices of both the Banc One and the Valley National organizations.

The Board has invited public comment over an extended period of time in this case and, as noted above, has received substantial submissions regarding the CRA performance of Banc One's and Valley National's subsidiary banks. In addition, the Federal Reserve Bank of Cleveland ("Reserve Bank") conducted an inspection of Valley National Bank's CRA performance as of November 1992 ("November Inspection") in conjunction with the OCC's examination of that institution. The results of this inspection were made available to Valley National, Banc One and the Protestants, and their comments in response to the inspection have been carefully considered by the Board.

As discussed in this Order, the record of these applications contains substantial information regarding the issues raised by the Protestants. In the Board's view, the record as it currently stands permits a fair evaluation of the CRA performance records of the Banc One and Valley National organizations and the convenience and needs factor of the BHC Act with respect to this proposal.

In this regard, the Board has carefully reviewed the CRA performance records of Banc One and Valley National and their respective subsidiary banks, the comments presented in written submissions and Banc One's and Valley National's responses to those com-

10. Protestants also have suggested that approval of this proposal should be conditioned upon Banc One's agreement to CRA-related commitments; upon the sale of Valley National's operations in California to an institution that would be more committed than Banc One to CRA-related objectives; or upon Banc One's presentation of a specific plan to improve the CRA performance record of Valley National Bank.

11. The Board notes that it recently examined the CRA performance record of Banc One's subsidiary in Texas, and concluded that this record was consistent with approval of a proposal by Banc One to expand its banking operations in that state. *See Banc One Corporation*, 78 *Federal Reserve Bulletin* 932 (1992)

Protestants also have raised issues that are not related to the record of performance by Banc One and Valley National under the CRA, including matters relating to third-party minority contracts, ethnic diversity within senior management and boards of directors, and equal employment opportunity throughout the work force While the Board fully supports affirmative programs designed to promote equal opportunity in every aspect of a bank's personnel policies and practices in the employment, development, advancement, and treatment of employees and applicants for employment, the Board believes that the alleged deficiencies in the organizations' general personnel and employment practices, including third-party contracting matters, are beyond the scope of the factors that may be assessed under the CRA or the convenience and needs factor of the BHC Act.

12. Several Protestants believe that notice of these applications should be republished in Spanish-language media. The Board's rules require, in addition to publication in the *Federal Register*, that notice of an application and a public comment period be published in a newspaper of general circulation in the communities in which the head offices of the applicant (or its largest subsidiary bank) and the banks to be acquired are located. 12 C.F.R. 225.14(b)(2) and 262.3(b). These publication requirements ensure that interested members of the public are afforded an adequate opportunity to present their views to the Board.

Other Protestants believe that a delay is warranted until anticipated changes in CRA and other policies relevant to the application can be implemented by the new Administration.

ments, and the November Inspection and comments related to that inspection, as well as all other relevant facts of record, in light of the CRA, the Board's regulations, and the Statement of the Federal Financial Supervisory Agencies Regarding the Community Reinvestment Act ("Agency CRA Statement").[13]

Record of Performance Under the CRA

A. Evaluations of CRA Performance

The Agency CRA Statement provides that a CRA examination is an important and often controlling factor in the consideration of an institution's CRA record and that these reports will be given great weight in the applications process.[14] In this regard, Banc One's lead subsidiary bank in Ohio, Bank One, Columbus, N.A., Columbus, Ohio ("Bank One Columbus"), received an "outstanding" rating at its most recent examination for CRA performance conducted by the OCC as of May 13, 1991. Among Banc One's other large subsidiaries in Ohio, the banks in Akron and Dayton also received "outstanding" ratings, and the banks in Cincinnati and Cleveland received "satisfactory" ratings, at their most recent examinations for CRA performance conducted by the OCC.[15] Overall, the most recent CRA performance examinations for Banc One's subsidiary banks show 19 "outstanding" ratings and 41 "satisfactory" ratings. Banc One has committed to integrate its CRA policies and programs at all the banks to be acquired from Valley National and, where appropriate, to supplement or replace Valley National's programs with its own.

The OCC has recently concluded a CRA performance examination of Bank One, Cleveland, N.A., Cleveland, Ohio ("Bank One Cleveland"), and the Board has been advised that the preliminary examination rating assigned to this institution is "needs to improve." As explained more fully below, Bank One Cleveland constitutes a small part of the overall Banc One organization, and the Board expects Banc One to address the areas of weakness identified by the OCC.

With respect to Valley National's examination record, all of Valley National's subsidiary banks for which public examination data are available have been rated "satisfactory" in their most recent examinations for CRA performance by their primary regulators.[16] In addition, the Board has been advised that the OCC recently concluded its CRA examination of Valley National Bank, and assigned the bank a CRA rating of "satisfactory." The OCC's CRA examination report has been forwarded to Valley National Bank, but has not yet become publicly available. The Board also has carefully reviewed the information collected in the November Inspection, as well as the responses to that inspection submitted by Protestants and other facts of record, regarding the CRA performance of Valley National Bank. In this regard, the November Inspection noted areas in which Valley National Bank's CRA performance record could be strengthened. For example, the inspection concluded that the CRA self-assessment measures adopted at Valley National Bank were somewhat limited, and involved no direct assessment performed by the board. In addition, the November Inspection indicated that ascertainment activities largely are not the result of an established, board-directed effort, but instead include a variety of formal and informal means utilized to ascertain local credit needs, including an officer calling program, customer surveys, contacts with public officials and neighborhood organizations, and focus group meetings with consumers and small businesses.[17] As discussed below, Banc One intends to address these areas of weakness by integrating its CRA policies and programs at Valley National.

B. Corporate Policies

Banc One has in place the types of policies and procedures that the Board and the other Federal bank supervisory agencies have indicated contribute to an effective CRA program. In this regard, Banc One monitors subsidiary bank CRA performance at both the corporate level and the state holding company level. At the corporate level, a corporate CRA committee, composed of the CRA officers of several state holding companies and senior corporate mortgage representatives, monitors community reinvestment performance of all Banc One affiliates and reports on this performance directly to the board of directors of Banc One. The CRA committee requires quarterly reports from all affiliate banks describing their CRA efforts. The CRA committee also reviews and updates corporate-wide CRA policy, monitors local issues to detect possible matters of concern, and conducts

13. 54 *Federal Register* 13,742 (1989).
14. *Id.* at 13,745.
15. Each of these examinations was conducted during 1991.
16. These examinations were conducted as follows:
(1) Valley Bank & Trust Company, N.A., Salt Lake City, Utah (OCC as of February 1992);
(2) Valley Central Bank, Richfield, Utah (Federal Deposit Insurance Corporation as of June 1991), and
(3) California Valley Bank, N.A., Fresno, California (OCC as of July 1990)
17. Generally, the November Inspection found that the center of Valley National Bank's ascertainment efforts had recently been redirected toward external discussions with local groups and organizations as opposed to internal analysis of community credit needs.

extensive CRA training programs. Company-wide training programs are held annually for bank CRA officers serving medium- and large-sized communities. In addition, the CRA committee has produced a CRA training video designed to instruct every Banc One employee on CRA policy, CRA reporting requirements, and CRA performance expectations. Banc One's corporate CRA Research Division assists Banc One's subsidiary banks in collecting and analyzing lending data to monitor the distribution of loan products throughout their delineated market areas.[18]

At the bank level, subsidiary banks file quarterly reports to their state holding company CRA Officer detailing the banks' CRA performance. The CRA officers also work together with internal bank CRA committees comprised of senior managers representing different areas of the bank such as marketing, retail lending and mortgage functions. Banc One requires that CRA officers be personally involved in reporting bank CRA performance to their local boards of directors to ensure that the directors maintain a comprehensive understanding of the bank's CRA efforts and performance. Each Banc One subsidiary bank utilizes Banc One's CRA Policy and Procedure Manual, which is updated to address changes in regulatory requirements or Banc One's policies. The manual sets forth the 12 assessment factors examined by federal regulators and includes Banc One's principles for subsidiary bank programs.

Banc One also requires each subsidiary bank to submit a strategic plan identifying local banking needs. Once these needs are identified, Banc One subsidiaries attempt to meet these needs through product development and modification, marketing initiatives, and community outreach programs.

Banc One's subsidiary banks also are encouraged to establish Community Advisory Councils to institutionalize the process of communication between the bank and its market. The banks utilize this resource to open avenues for enhanced market penetration and to foster a better understanding between the bank and the community. In addition to Banc One's company-wide CRA training program, state holding company CRA officers also hold monthly or quarterly information and training sessions for all bank CRA officers in their state.

Valley National Bank's board of directors and senior management also provide oversight and direction of CRA activities through three standing committees, the CRA Policy Committee, the CRA Public Policy Committee, and the CRA Implementation Committee. As previously noted, Banc One has stated that it will integrate Valley National into its own CRA program. Specific elements of the Banc One program to be incorporated include: detailed quarterly reporting on CRA matters, which will be furnished to the boards of directors and senior management of the institutions to be acquired; direct contact between Valley National Bank's CRA Officer and its board of directors; and the review of quarterly CRA reports at board meetings. In addition, Banc One intends to enhance other elements of the Valley National Bank CRA program, as discussed in this Order and in Banc One's response to the November Inspection.

C. Ascertainment and Marketing

Banc One affiliates actively assess the credit and banking needs of their local service areas. Each affiliate bank is responsible for formulating and submitting to its board of directors a strategic plan for identifying local banking needs. Each bank engages in direct communication with its service communities through interviews with community leaders, the creation of community advisory councils, and bank participation in community organizations.

With respect to ongoing marketing efforts, Banc One has distributed a *CRA Marketing and Advertising Guide* to all affiliate banks which instructs subsidiary banks on such matters as the relationship between CRA goals and general marketing objectives, the characteristics of populations with special credit needs, and creative requirements and advertising copy points to be considered in penetrating particular markets.[19] Banc One also markets specific banking products by advertising on television and radio and in print media. In specific markets, corporate marketing materials are supplemented where deemed appropriate.[20] With respect to its marketing efforts in the Hispanic community, certain Banc One subsidiaries provide Spanish-language home buyer counseling, bilingual ATM service, and Spanish-language brochures on basic banking products. Banc One's subsidiary banks also employ bilingual mortgage originators in communities where such expertise is warranted. In addition, Bank One, Texas, N.A., Dallas, Texas, has developed numerous Spanish-language print advertisements which

18 Banc One's CRA Research Division has provided training in understanding HMDA aggregation tables and ensures that all affiliates file complete and accurate reports of residential lending activity. This has enabled affiliate banks to identify areas of opportunity or concern and to target initiatives so as to address perceived needs.

19 This guide also includes a selection of product-specific advertisements that can be customized for particular markets where government programs are available.

20 For example, Banc One runs a national television media campaign. In addition, the Banc One organization advertises on a Spanish-language television station in the Milwaukee, Wisconsin area and on the Black Entertainment Network in the Lima, Ohio area.

it has made available to other Banc One subsidiaries that might benefit from their use.

Valley National Bank's ascertainment activities are administered by its board of directors and senior management, which provide direction through the formulation of the bank's CRA Mission Statement and CRA Strategic Action Plan, as well as oversight and monitoring of these efforts. The Strategic Action Plan details the process that the bank has established to identify community credit needs, to research how the bank might respond to those needs, and to develop or enhance products and services designed to meet those needs. Valley National Bank also has designed a comprehensive marketing plan which articulates the various methods to be used for promoting the bank's credit products and services throughout its delineated communities, including low- and moderate-income areas.

Banc One has indicated that it intends to continue Valley National Bank's recent orientation toward ascertainment activities that are based upon direct contact with community representatives as opposed to institutional reflection regarding community credit needs. Banc One also intends to review the community delineations of Valley National Bank, and has indicated that the institution should have at least four regional markets in the State of Arizona, each with a full-time CRA Officer dedicated to understanding community credit needs and evaluating the extent to which the bank is successful in meeting such needs. Evaluations of CRA performance also will be conducted on a market-by-market basis as opposed to the current state-wide system of review. In addition, the ascertainment methods currently employed by Valley National Bank will be supplemented by locally-appointed Community Advisory Councils and geodemographic reports compiled by Banc One's CRA Research Division. With respect to CRA-related marketing, Banc One will require that the bank's CRA Officer attend and participate in meetings of marketing personnel. Banc One expects that the continuing and active participation of the CRA Officer in all activities of the marketing department will be effective to ensure that all marketing initiatives are sensitive to the institution's CRA-related objectives.

D. Banc One's Lending and Other Activities

Banc One has instituted or participates in a number of programs designed to provide a variety of credit products to low- and moderate-income and minority persons. At the corporate level, Banc One has established a system-wide Community Development Corporation ("CDC") with resources to assist all bank affiliates in financing projects designed to promote community welfare, housing availability and economic development. As of December 1992, the CDC had provided $20 million in equity for low-income housing projects utilizing low-income housing tax credits.

Banc One also has a mortgage subsidiary, Banc One Mortgage Corporation, which assists affiliates by offering specialized mortgage products designed for low- and moderate-income applicants. In addition, the mortgage subsidiary has created and sponsors an affordable housing lender program, through which affiliates with sufficient customer demand for affordable housing have employed mortgage originators specialized in affordable housing loans and low-income mortgage products.

Banc One requires all affiliate banks to participate in federal, state, and local lending programs which are designed to assist disadvantaged populations such as racial and ethnic minorities and the poor, disabled, or elderly, including particularly those programs sponsored by the Small Business Administration, the Department of Housing and Urban Development, and the Federal Housing Administration. Banc One subsidiaries are certified SBA lenders and have made millions of dollars of loans through this program. Banc One subsidiaries also provide funding for other programs designed to help finance small businesses, including the Minority Enterprise Small Business Investment Corporation and the Cleveland Micro Loan Program.

Banc One subsidiaries also have made investments in numerous programs designed to help provide housing for low-income families, including the Cincinnati Equity Fund, the Cleveland Housing Network, and the Cleveland Neighborhood Equity Fund. Banc One also holds an annual Retail Lending Conference, which focuses on such matters as the collection and use of geocoded information for market delineation and understanding bank performance with respect to the equitable distribution of credit.

Banc One affiliate banks may design and promote special lending programs which, by their interest rates, amortization schedules, and collateral requirements, target particular types of credit needs. Banc One also encourages its subsidiary banks to be flexible in the application of lending criteria to low-income populations. Examples of such flexibility include the financing of points and closing costs in mortgage loans, and the use of a 95 percent loan-to-value ratio for loans with mortgage insurance.

The Board also has reviewed Banc One's loan products and community development activities in light of Protestants' comments on a city-by-city basis. In each of the principal cities in which it operates, Banc One has put in place a number of programs designed to help meet the credit needs of its service communities, including the following:

Cincinnati. In Cincinnati, Banc One has hired an affordable housing lender and offers products targeted to low- and moderate-income home buyers such as the Community Homebuyer ½ mortgage and a loan product with flexible underwriting guidelines. Banc One also supplements the efforts of its affordable housing originator with targeted marketing strategies such as outdoor advertising, minority-audience media, and advertisements on bus benches in target neighborhoods. The Cincinnati bank also uses the services of a minority appraiser and participates in numerous home buying seminars. The bank recently hired a research manager to develop a more comprehensive system to analyze the geographic distribution of loans.

In 1989, Banc One began offering in Cincinnati both FHA and Ohio Housing Finance Agency ("OHFA") First Time Homebuyer loans, which feature below-market interest rates and reduced down payments. In 1990, 21 percent of the bank's home purchase loans in the Cincinnati area were FHA loans. The bank also introduced in 1990 a new home equity loan product which allows individuals to borrow up to 100 percent of the equity in their homes.

Banc One also has committed $250,000 through its CDC to a low-income housing tax credit investment in the Cincinnati Equity Fund to rehabilitate housing in low- and moderate-income neighborhoods, and has invested $1 million in the Ohio Equity Fund in connection with low-income housing. Banc One has recently established a Cincinnati/Hamilton County Community Advisory Council as part of its effort to serve the Cincinnati market.

Banc One has focused on improving originations of its home improvement loan products in the Cincinnati market.[21] Banc One's lending under this program has increased from only 8 minority borrowers in 1990 to 82 borrowers in 1991 and 130 borrowers through the third quarter of 1992. In addition, in its most recent examination, the OCC stated that the bank's loan volume was adequate in relation to the institution's resources and community credit needs.[22]

The majority of the bank's commercial loans are to small businesses. In June 1992, Banc One established a Business Banking Division in Cincinnati and hired six commercial lenders to assist the bank in accommodating the credit needs of small and minority businesses. Banc One representatives also serve on committees and projects that help fund small businesses.

Columbus. Bank One Columbus offers loans through FHA, VA, and OHFA loan programs. In 1990, the bank closed 85 housing loans through these programs in the aggregate amount of $4.5 million. In addition, in 1990 the bank generated 570 home mortgage loans totalling $31.5 million and 1871 home improvement loans totalling $19 million within its market area. The bank also has adopted real estate loan programs with flexible underwriting standards and expanded consumer education in an effort to help address the affordable housing needs of the community.

In the Columbus market, Banc One approved 529 loans to small businesses through the first three quarters of 1992 in the aggregate amount of $27.3 million.[23] Banc One conducts its small business lending in Columbus through the Business Banking Group, which has a target market that includes businesses owned by women and minorities. Outreach activities include media advertising, direct mailings, telemarketing, newsletters, direct calling, and special promotions. The bank also provides special educational and informational services to businesses, and works with community and government groups to enhance lending opportunities to targeted businesses.

Banc One is involved in community development activities throughout the Columbus market. The bank committed $3.5 million to the Columbus Housing Partnership for affordable housing projects. The bank also participated in funding the Urban Land Institute's recent study of the Columbus area's housing needs, and now is addressing the study's results. In addition, the bank utilizes the corporate CDC in addressing community needs. On behalf of the bank, the CDC invested $1.3 million in two Franklin County projects sponsored by the Columbus Housing Partnership and Urban Rental Housing Development.

Dayton. Banc One has taken steps to improve significantly its lending to low- and moderate-income individuals in the Dayton area. In response to ascertained credit needs, Banc One has developed in Dayton a purchase-rehabilitation loan program, and has added FHA and VA mortgage products. The bank also has developed mortgage products which offer flexible lending criteria and lower down payments. An example of this is the Community Home Buyers Program,

21. In this regard, the bank recently implemented improved procedures to ensure that all home equity loans used for home improvement purposes are reported on the HMDA loan register.

22. The bank's loan mix has a larger concentration of 1–4 family residential loans, home equity loans, loans to individuals, and municipal loans, and a smaller concentration of commercial and industrial loans, than banks with similar asset sizes and branching structures. The institution's loan mix at the end of 1990 included 48 percent real estate loans, 31 percent loans to individuals, 13 percent commercial and industrial loans, and 3 percent municipal loans. Of the real estate loans, 31 percent were for 1–4 family residential homes and 14 percent were for home equity loans.

23. Through the third quarter of 1992, the regional office of the SBA reported that no other lender in the fifty-two county region had extended more SBA loans.

where down payment and other underwriting requirements are reduced for low- and moderate-income individuals. Other housing-related loan programs are offered in conjunction with the bank's Historic Restoration Mortgage and the Sponsored Purchase Mortgage program, under which a non-profit organization can participate in creating affordable housing for low- and moderate-income individuals. The bank also regularly extends loans through the Vision Loan program, which is designed to provide affordable housing for low- and moderate-income home buyers in the area, and through the City of Dayton's Neighborhood Lending Program. The bank is the leading lender in the Neighborhood Lending Program's home purchase and purchase-rehab program, which provides an interest buy-down feature by the City of Dayton during the first three years of the mortgage loan. The bank also participates in the OHFA First Time Homebuyer Program, which offers below-market interest rates and reduced down payment requirements.

Through the Banc One CDC, the bank is an equity participant in County Corp's Homestart II Program, which is designed to develop affordable housing. The bank also is involved through the CDC in the McPherson Town neighborhood renovation program, to which Banc One has provided funding for the acquisition, renovation, and resale of residential properties.

In 1990, the bank closed 110 FHA and VA loans, representing approximately 29 percent of the bank's home purchase and refinancing loans during the period. In addition, the bank made 57 residential mortgage loans in low- and moderate-income census tracts in 1990.

In 1992, Banc One in Dayton introduced a small business revolving line of credit offered to businesses with less than $2 million in annual sales. The bank has approved over 100 applications for this product representing over $2 million in credit commitments. Banc One also has committed $200,000 in loans to the Dayton-Montgomery MicroEnterprise Fund, and has recently agreed to invest an additional $90,000 in the Minority Enterprise Small Business Investment Corporation, which would raise the bank's total investment in this corporation to $175,000 and make it the largest investor in this fund.

The Dayton bank is a certified SBA lender and has made nearly 60 SBA-guaranteed loans totalling $14 million in the past four years. Through September, Banc One had extended 11 SBA loans for a total of $2 million in 1992. In 1990, the Dayton bank made 63 loans totalling $7.7 million to small businesses located in areas with a minority population of at least 20 percent. This figure increased to 69 loans totalling $8.4 million in 1991.

E. Valley National Bank's Lending and Other Activities

Banc One has indicated that it intends to enhance Valley National Bank's lending programs upon consummation of this proposal. For example, Banc One intends to incorporate the bank's Low/Moderate Income Mortgage Lending Program into Banc One's affordable housing lender program, which includes review of all denied loan applications and specialized underwriting personnel. Banc One also will expect Valley National Bank to employ the resources of the Banc One CDC as well as government programs for community or economic development.

Banc One has noted, however, that Valley National Bank has developed a number of programs designed to meet the credit needs of low- and moderate-income populations in Arizona. Banc One expects this bank following consummation to continue these products and programs to the extent they are effective in meeting local credit needs. Banc One expects that Valley National Bank will continue to be an active participant in government-sponsored loan programs, and that CRA officers will work with local government officials to modify or develop programs in response to the changing needs of their respective service communities.

The November Inspection indicated that Valley National Bank offers a wide range of loan products throughout its delineated communities. In the area of single-family housing loans, the bank offers, in addition to an array of traditional mortgage products, various loan programs targeted to the credit needs of low- and moderate-income households. For example, Valley National Bank's Express Mortgage Program was developed to enable lower-income families to obtain, through a simple application process, long-term fixed-rate mortgages in amounts from $10,000 with no mortgage points. In the first two months after its introduction, the bank approved over 1,000 loans under the Express Mortgage Program for a total of approximately $33.5 million. The bank also has introduced a Low/Moderate Income Mortgage Lending Program under which low- and moderate-income applicants may obtain long-term fixed-rate mortgages for the purchase of affordable housing. The program provides for flexible underwriting criteria and down payment requirements. Valley National Bank has established a fund of $10 million to fund these loans for the first year of the program, and has hired three loan officers to manage the product from designated low- and moderate-income branches.

Valley National Bank also helps to meet the credit needs of low- and moderate-income home owners through joint efforts with such organizations as Hous-

ing for Mesa, Catholic Social Services of Tucson, Comite De Bienestar, and the Tucson Urban League. In addition to these private efforts and the programs designed by the bank itself, Valley National Bank also participates in various government-sponsored loan programs targeted to the needs of lower-income households, including the FNMA Community Home Buyers Program and Neighbors Mortgage Loan Program, the Veterans Administration No Down Payment Loan Program, and the HUD 203(k) and 221(d)(2) programs.

The bank also offers home equity loans on both fixed- and variable-rate terms for up to 100 percent of the borrower's home equity, as well as FHA- and HUD-sponsored home improvement loan programs, and participates to a significant extent in the City of Phoenix Home Improvement Loan program.[24]

To improve credit services to small businesses, Valley National Bank opened its Small Business Loan Center in April 1991, and in January 1992 organized the Small Business Banking Division. These groups were established to work with businesses with annual sales of not more than $1 million and aggregate credit needs of $250,000 or less. The bank is a significant lender to small businesses, with $142 million in its small business loan portfolio as of September 1992.[25] Valley National Bank also participates in a SBA-sponsored lending program for small businesses, and has begun to increase the number and amount of loans made under this program.

The bank also participates to a significant extent in community development and redevelopment projects. In addition to significant purchases of municipal bonds issued by its local communities, the bank is receptive to meeting articulated financial needs on both an individual and joint-efforts basis. In this regard, the November Inspection concluded that the bank appears to be committed to investing in development and redevelopment projects. For example, Valley National Bank provided $3 million of the initial $10 million of funding for the Arizona Multibank Community Development Corporation, which was established by the Arizona Bankers Association to provide financial and technical assistance for the advancement of small business, low- and moderate-income housing, and economic development. The bank also has joined with a non-profit organization to provide credit to small, family-owned businesses, and provides funding to various business development and housing rehabilitation programs.

F. HMDA Data and Lending Practices

The Board has reviewed the HMDA data reported by subsidiary banks of Banc One and Valley National in light of Protestants' comments. Data cited by Protestants indicate some disparities in approvals and denials of loan applications according to racial and ethnic group and income status in the areas served by these organizations. Because all banks are obligated to adopt and implement lending practices that ensure not only safe and sound lending but also equal access to credit by creditworthy applicants regardless of race, the Board is concerned when the record of an institution indicates disparities in lending to minority credit applicants. The Board recognizes, however, that HMDA data alone provide only a limited measure of any given institution's lending in its community. The Board also recognizes that HMDA data have limitations that make the data an inadequate basis, absent other information, for conclusively determining whether an institution has engaged in illegal discrimination on the basis of race or ethnicity in making lending decisions.

The most recent examinations for CRA compliance and performance conducted by bank supervisory agencies found no evidence of illegal discrimination or other illegal credit practices at any subsidiary bank of Banc One or Valley National. In addition, the November Inspection found no illegal credit practices or discrimination at Valley National Bank.

HMDA data also show some improvement in certain areas of lending to minorities and to low- and moderate-income credit applicants by the Banc One organization. These improvements appear to have resulted from steps taken by the organization to improve its lending record, such as the affordable housing lender program and the activities of the CRA Research Division discussed above.

G. Recent CRA Examination of Bank One Cleveland

In connection with its recent CRA examination of Bank One Cleveland, the OCC has preliminarily rated the CRA performance of this institution as "needs to improve." The Board notes that Bank One Cleveland represents less than 5 percent of Banc One's total consolidated assets. As previously discussed in this Order, the Banc One organization has a demonstrated history of compliance with the CRA, and the remaining banking assets of the Banc One organization are in

24. Valley National Bank has approved loan requests totalling approximately $3.75 million under this program, which provides for subsidized interest rates and a maximum loan amount of $15,000.

25. The Board notes that 14 percent of the bank's small business borrowers are located in minority census tracts.

institutions rated "satisfactory" or "outstanding" for CRA performance.

In this regard, the Board notes that Bank One Cleveland's preliminary rating of "needs to improve" represents a recent downgrading from the current rating of "satisfactory" for this institution. The Board expects Banc One to take steps that will address the areas of weakness identified in the OCC's most recent examination. In addition, Banc One must submit to the Board, when delivered to the OCC, a copy of the plan to address the weaknesses in the CRA performance record of Bank One Cleveland identified by the OCC. Banc One also must report to the Reserve Bank, on a quarterly basis commencing June 30, 1993, as to its progress in remedying these problems and implementing the plan for improvement. Banc One's progress in remedying these deficiencies will be taken into account in connection with future applications by Banc One.[26]

H. Conclusion Regarding Convenience and Needs Factor

The Board has carefully considered all of the facts of record, including the comments filed in this case, in reviewing the convenience and needs factor under the BHC Act. Based on a review of the entire record, including the findings of the November Inspection, information provided by commenters supporting and opposing this proposal, and the results of CRA performance examinations conducted by the respective primary regulators of the subsidiary banks of Banc One and Valley National, the Board believes that the efforts of Banc One and Valley National to help meet the credit needs of all segments of the communities served by their subsidiary banks, including low- and moderate-income neighborhoods, as well as all other convenience and needs considerations, are consistent with approval of this proposal.[27]

Other Considerations

Banc One and Valley National do not compete in any banking market. Hence, the Board has concluded that the proposed acquisition would not adversely affect competition in any relevant banking market.[28] The Board also has concluded that the financial and managerial resources[29] and future prospects of Banc One, Valley National, and their respective subsidiaries, and all other supervisory factors the Board must consider under section 3 of the BHC Act, are consistent with approval of this proposal.

Banc One also has applied, pursuant to section 4(c)(8) of the BHC Act, to acquire Concho Insurance, a company that provides credit-related life and disability insurance issued in connection with extensions of credit by Valley National Bank, and VNC Investment, a company that engages in the making and arranging of commercial loans.[30] These activities are permissible for bank holding companies under the Board's Regulation Y,[31] and Banc One proposes to conduct these activities in accordance with the Board's regulations.

In order to approve this application, the Board also must find that the performance of the proposed activities by Concho Insurance and VNC Investment "can

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26 One Protestant has requested that the Board delay consideration of these applications to permit consideration of the OCC's pending CRA performance examination of Bank One Cleveland As discussed in this Order, the Board has taken into account the preliminary examination rating assigned to Bank One Cleveland by the OCC rather than delay consideration of these applications

27. Certain of the Protestants have requested that the Board hold a public meeting or hearing with respect to this application. The Board is not required under section 3 of the BHC Act to hold a public hearing unless the primary supervisor for the bank to be acquired disapproves the proposal. In this case, the primary supervisors for the institutions to be acquired have not objected to Banc One's application

Under its rules, the Board may, in its discretion, hold a public meeting or hearing on an application to clarify factual issues related to the application and to provide an opportunity for testimony, if appropriate 12 C F R 262 3(e) and 262 25(d) The Board has carefully considered Protestants' requests for such a meeting or hearing, and the written comments submitted by Protestants In the Board's view, interested parties have had ample opportunity to submit and have submitted substantial written comments that have been considered by the Board Moreover, Protestants have indicated general disagreement regarding the appropriate conclusions to be drawn from the facts of record, but have not identified facts that are in dispute and material to the Board's decision. In light of these considerations, the Board has determined that a public meeting or hearing is not necessary to clarify the factual record in this application, or otherwise warranted in this case Accordingly, the requests for a public meeting or hearing on this application are hereby denied.

28 In this regard, one commenter has maintained that the proposal would result in a undue concentration of banking resources in Banc One

29. In addressing the managerial considerations of this proposal, the Board has carefully considered several comments that related to the operations of the subsidiary banks of Banc One and Valley National. Some comments related to particular consumer and business dealings, including loan transactions and payroll processing matters, involving certain of these institutions. Other commenters have alleged, without providing any supporting facts or documentation, that management officials of the Banc One and Valley National organizations have engaged in improper, and in some cases criminal, activity and conduct. The Board has reviewed these comments in light of all of the facts of record in this case, including information responding to these comments provided by Banc One and Valley National, relevant examination reports, and information provided by other federal regulatory agencies. Based on this review, the Board has concluded that these comments do not reflect so adversely upon the managerial resources of these organizations as to warrant denial of this proposal

30 VNC Investment also is an investment company which invests in debt and equity securities which do not comprise more than 5 percent of the voting securities of any issuer. This is an activity permitted to bank holding company subsidiaries without the Board's prior approval under section 4(c)(7) of the BHC Act and section 225 22(c)(6) of the Board's Regulation Y

31 *See* 12 C F R 225 25(b)(8)(i) and 225 25(b)(1)

reasonably be expected to produce benefits to the public . . . that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices." 12 U.S.C. § 1843(c)(8). The Board expects that the continuance of these activities by these nonbanking subsidiaries would maintain the level of competition among providers of these services. In addition, there is no evidence in the record that consummation of this proposal would result in any significantly adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices. Accordingly, the Board concludes that the balance of the public interest factors that it is required to consider under section 4(c)(8) of the BHC Act is favorable, and consistent with approval of Banc One's section 4 application.

Based on the foregoing and other facts of record, the Board has determined that the application should be, and hereby is, approved. This approval is specifically conditioned upon compliance by Banc One with all of the commitments made in connection with this application and with the conditions referenced in this Order. The Board's determination with respect to its nonbanking activities also is subject to all of the conditions set forth in Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require such modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders issued thereunder. For purposes of this action, the commitments and conditions relied on in reaching this decision shall be deemed to be conditions imposed in writing by the Board and, as such, may be enforced in proceedings under applicable law.

The banking acquisitions shall not be consummated before the thirtieth calendar day after the effective date of this Order, and the proposal shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board or by the Federal Reserve Bank of Cleveland, acting pursuant to delegated authority.

By order of the Board of Governors, effective March 1, 1993.

Voting for this action: Chairman Greenspan and Governors Mullins, Angell, Kelley, LaWare, Lindsey, and Phillips.

JENNIFER J. JOHNSON
Associate Secretary of the Board

First Bank System, Inc.
Minneapolis, Minnesota

Order Approving the Acquisition of a Bank Holding Company

First Bank System, Inc., Minneapolis, Minnesota, and its wholly owned subsidiary, Central Bancorporation, Inc., Denver, Colorado (together, "FBS"), both bank holding companies within the meaning of the Bank Holding Company Act ("BHC Act"), have applied under sections 3(a)(3) and 3(a)(5) of the BHC Act (12 U.S.C. § 1842(a)(3) and (a)(5)), to acquire all of the voting shares of Colorado National Bankshares, Inc., Denver, Colorado ("CNB"),[1] and thereby indirectly acquire CNB's eight subsidiary banks: Colorado National Bank, Denver, Colorado; Colorado National Bank-Belmont, Pueblo, Colorado; Colorado National Bank-Pueblo, Pueblo, Colorado; Colorado National Bank-Glenwood, Glenwood Springs, Colorado ("CNB-Glenwood"); Colorado National Bank-Grand Junction, Grand Junction, Colorado ("CNB-Grand Junction"); Colorado National Bank-Longmont, Longmont, Colorado; Colorado National Bank-Fort Collins, Fort Collins, Colorado; and Colorado National Bank-Exchange, Colorado Springs, Colorado.[2]

FBS also has applied under section 4(c)(8) of the BHC Act to engage in nonbanking activities through the acquisition of the following CNB subsidiaries pursuant to section 225.25(b)(8)(i) of the Board's Regulation Y (12 C.F.R. 225.25(b)(8)(i)):

(1) Colorado National Insurance Agency, Inc., Denver, Colorado, and thereby engage in selling credit life, and accident and disability insurance; and

(2) Colorado National Life Insurance Company, Inc., Denver, Colorado, and thereby engage in reinsuring credit life, and accident and disability insurance.

Notice of the applications, affording interested persons an opportunity to submit comments, has been published (58 *Federal Register* 4,436 (1993)). The time for filing has expired, and the Board has considered the application and all comments received in light of the factors set forth in sections 3 and 4 of the BHC Act.

FBS, with total consolidated assets of approximately $23.4 billion, controls 21 subsidiary banks and

1. CNB will merge into Central Bancorporation, Inc. and the resulting entity will operate in Colorado using the CNB name.

2. In connection with FBS's proposed acquisition of CNB, FBS has requested Board approval under section 3 of the BHC Act to acquire an option to purchase up to 20.6 percent of the voting shares of CNB. This option will become moot upon consummation of FBS's application to acquire CNB.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BOND FROM EUGENE A. LUDWIG

Q.1. Although CBO has been quoted as saying that the savings from the Administration's plan would be quite small, the Secretary claimed that it would save the Government $150 to $200 million annually. Do you believe that the same amount of money would be saved by the proposal the Federal Reserve has put forward?

A.1. Dear Senator Bond, after the hearings concerning agency consolidation, you inquired whether the Administration's proposal would save the same amount of money as the proposal put forward by the Federal Reserve Board. Although the OCC has not developed its own estimate of savings from the Federal Reserve's proposal, my understanding is that the Office of Management and Budget has evaluated both the Federal Reserve's and Administration's proposals. According to my staff, OMB estimates that the Federal Reserve's proposal would not produce as much in long-term savings as the Administration's bill for the following reasons: (i) The two agency structure would achieve lower economies of scale than the single agency approach; (ii) both agencies (the proposed Federal Banking Commission and the Federal Reserve) would separately need to maintain expertise in all types of banks and thrifts; and (iii) greater duplication would persist under the Federal Reserve's proposal since many of the large banking companies and their subsidiaries would be supervised by both the Federal Reserve and the Federal Banking Commission.

Q.2. Please furnish the Committee with a list of all of the agencies, and the individuals who represent them, who are a part of the interagency task force on bank regulatory consolidation mentioned by Secretary Bentsen during the hearing of March 1, 1994. In addition, please provide us with the date the task force was formed, a schedule of all the meetings held, and a list of who attended each meeting. I would appreciate your response by March 9, 1994.

A.2. You also asked, at the hearing, whether any member of my staff or I had discussed the consolidation issues and proposals with any member of the White House staff and, if so, whether any matter relating to Worthen Banking Corporation, Worthen Bank of Little Rock, Worthen Financial, Madison Guaranty Savings and Loan, or Whitewater was brought up. You inquired, specifically, whether I had any discussions with Webster Hubbell and whether I knew who was representing the Department of Justice on issues relating to the consolidation proposal. After the hearing, you also asked the OCC to provide a list identifying the individuals who represented the agency on an "interagency task force on bank regulatory consolidation" and the dates of those "task force" meetings.

Because the OCC did not anticipate the need to reconstruct the history of the Administration's consolidation proposal, it did not systematically maintain records of all meetings or discussions relating to this subject. In order to be able to respond to your inquiry, I therefore directed the OCC's Chief Counsel's Office to undertake a comprehensive internal review to identify all information within the OCC which might be responsive to your inquiry. This response is based on the results of that review and my own best recollection.

Since the fall of 1993, I participated in a number of meetings and telephone discussions on the issue of Federal banking agency consolidation with other Members of the Administration. The effort got underway in earnest at a meeting on October 19, 1993, which included several Members of the Administration, including the President, and at which a variety of issues were discussed involving the state of the banking industry and ways the industry could best support economic revitalization. Enclosed is a chart identifying, as best we can reconstruct from the OCC's records, the recollections of OCC staff, and my own recollection, all the subsequent interagency meetings that involved any substantive discussions of the agency consolidation proposal. Although no formal "interagency task force" was ever set up, there were, as you can see from the chart, a large number of meetings among Members of the Administration in which the OCC participated. Among these meetings were several in which officials from various White House offices also participated, including OMB, NEC, CEA, OPM, the Office of Legislative Affairs, and the Office of the Counsel.

I should note that, because the development of the Administration's agency consolidation proposal was a comprehensive undertaking involving numerous participants and a large number of telephone calls, meetings, and other discussions, it has been impossible to reconstruct the dates and participants in meetings and calls identified in the enclosed chart with absolute certainty. Furthermore, I attended a number of gatherings and had a considerable number of telephone calls with Members of the Administration on other banking matters. In some of these meetings and in some of the telephone calls, there were passing or other incidental references to the agency consolidation proposal. Due to the incidental and genuinely unimportant nature of such references to agency consolidation, I cannot reconstruct with any accuracy when and with whom these meetings and telephone calls took place.

Among the issues discussed in the meetings and calls referred to in the enclosed chart were the organization and structure of the Federal Banking Commission, including, particularly, its independence. In that regard, the OCC participated in a number of discussions regarding the litigating authority of the proposed Federal Banking Commission. At the hearings on agency consolidation, I identified Walter Dellinger as the representative from the Department of Justice I remembered. I also stated that I did not have any discussions with Mr. Hubbell and that, to the best of my knowledge, he was not involved in discussions concerning agency consolidation. At the time I provided my testimony, I did not have any information indicating that Mr. Hubbell was involved in such discussions. Subsequent to my testimony, however, I was advised that Mr. Hubbell may have been involved in discussions of the Federal Banking Commission's litigating authority in which neither my staff nor I participated. I would like to amend the hearing record to that effect.

At no time during any of the meetings or telephone calls in which the agency consolidation proposal was developed did any member of my staff or I participate in any discussion of substantive or procedural questions relating to Worthen Bank Corporation, Worthen Bank of Little Rock, Worthen Financial, or any other in-

stitution, that might be pending before the OCC or any of the other Federal banking agencies, nor did we discuss how the resolution of any such matter might be affected by the consolidation proposal.

With regard to Madison Guaranty Savings and Loan and Whitewater, several members of my staff and I recall passing references to the recent publicity surrounding those matters in various conversations. Even these passing references were only made in the context of whether the controversy might affect congressional views regarding elements of the consolidation proposal, or with regard to how to structure the proposed Federal Banking Commission as an independent agency in order to prevent the consolidation proposal from being caught up in the controversy. On no occasion, including those referred to above, did I, or, to the best of my knowledge, anyone on my staff provide or receive any nonpublic information relating to Worthen, Madison Guaranty Savings and Loan, or Whitewater.

I trust this is fully responsive to your request. If either you or your staff have questions concerning any agency consolidation meetings or other discussions in which you believe my staff or I may have participated and which our review has failed to identify, we would be happy to check further to determine whether our records contain any indication of OCC participation. I appreciate your interest and look forward to working with you as we continue the important work of consolidation of the bank regulatory system.

APPENDIX A

This Appendix contains a listing of meetings and conference calls held that could be characterized as a meeting of the "interagency task force", other than meetings within the OCC or meetings held with Treasury or Treasury bureaus, to discuss consolidation and the names of the participants at each meeting. This information was obtained from the records and recollection of OCC participants and may not include all the participants or all the meetings, since attendance lists were not generally maintained.

OCC: Office of the Comptroller of the Currency
NEC: National Economic Council
CEA: Council of Economic Advisors
FDIC: Federal Deposit Insurance Corporation
OMB: Office of Management and Budget
OPM: Office of Personnel Management
DOJ: U.S. Department of Justice
OTS: Office of Thrift Supervision

DATE	PARTICIPANTS	SUBJECT MATTER
11/10/93	OCC: Gene Ludwig Konrad Alt Julie Williams Treasury Representatives[1] NEC: Ellen Seidman CEA[2], OMB[3]	A meeting to discuss the options for structuring the regulatory consolidation proposal.

[1] Unless otherwise specifically mentioned, the Treasury representatives may have included the following individuals: Frank Newman, Rick Carnell, David Lebryk, Brian Mathis, Fe Morales Marks, Roberta McInerney, and Peter Bieger. Frank Newman attended most of the meetings, but not all. Gordon Eastburn, Steve McHale, Brian Tishuk, John Lewis and a few other Treasury staff members participated in some meetings but not all. Attendance lists were not maintained for most meetings and, therefore, it is not possible to state with absolute certainty which members of the Treasury staff attended which meetings.

[2] The likely participants from CEA were the following: Constance Dunham, Joe Stiglitz, and on one occassion, Alan Blinder. In light of the fact that the same people did not attend each meeting and since attendance lists were not maintained for most meetings, it is not possible to state with absolute certainty which members attended which meetings.

[3] In light of the fact that the same people did not attend each meeting and since attendance lists were not maintained for most meetings, it is not possible to state with absolute certainty which members attended which meetings. Usually Alan Rhinesmith and Alice Cho represented OMB at the meetings. Other OMB participants at various meetings may have included Chris Edley, Sally Katzen, Jeff Hill, Jim Jukes, Peggy Kuhn, and Doug Steiger.

12/13/93	OCC: Gene Ludwig Julie Williams Treasury Representatives NEC: Ellen Seidman CEA,OMB	A meeting to discuss follow-up on the regulatory consolidation proposal.
12/14/93	OCC: Gene Ludwig Konrad Alt Julie Williams Treasury Representatives NEC: Ellen Seidman DOJ: Mike Small Dawn Johnsen CEA,OMB	A meeting to discuss consolidation issues.

12/16/93	OCC: Jim Kamihachi John Carlson Tom Lantzas Roy Madsen Ron Passero Treasury: Becky Ellis Gordon Eastburn Brian Tishuk John Lewis OMB: Alan Rhinesmith Alice Cho Peggy Kuhn OTS: Bill Durbin Richard Abood Gail Saunders FDIC: Steve Selig Betty Johnston	A meeting at OMB to discuss what information OMB would need to make its estimate of the budget, personnel costs and savings associated with the Administration's proposal.
12/20/93	OCC: Gene Ludwig Treasury: Rick Carnell NEC: Ellen Seidman CEA: Joe Stiglitz OMB: Chris Edley	A meeting to discuss bank regulatory consolidation.

12/27/93	OCC: Gene Ludwig NEC: Ellen Seidman	A telephone conversation to discuss agency consolidation.
01/03/94	OCC: John Carlson Gary Norton Ron Crain Judy Walter FDIC: Al Squerrini Steven Seelig Betty Johnston OPM: Gay Gardner OTS: Bill Durbin Bill Casey Kevin Petrasic Jeff Miner Treasury: Steve McHale Peter Bieger Brian Tishuk Gordon Eastburn John B. Lewis Linda Oakey-Hemphill OMB: Ray Kogut Peggy Kuhn Alan Rhinesmith Alice Cho	A meeting to discuss the personnel issues relating to banking regulatory consolidation.

01/04/94	OCC: Ron Crain Treasury: Steve McHale OTS: Bill Durbin Bill Casey FDIC: John Chiporus OMB: Alice Cho OPM: Gay Gardner	A meeting held at Treasury to discuss benefit plan transition issues.
01/11/94	OCC: Julie Williams Treasury Representatives NEC: Ellen Seidman CEA.OMB	A meeting to discuss resolution of outstanding issues in regulatory consolidation proposal.
01/12/94	OCC: Konrad Alt Bill Bowden Julie Williams Jim Kamihachi John Carlson Eileen Gallagher Leonora S. Cross Treasury Representatives NEC: Ellen Seidman	A telephone conference call regarding items remaining to be accomplished and followed-up on.

01/12/94	OCC: Gene Ludwig Julie Williams Leonora S. Cross Eileen Gallagher Konrad Alt Jim Kamihachi John Carlson Treasury Representatives OTS: Jonathan Fiechter NEC: Ellen Seidman Paul Dimond Paul Weinstein CEA: Constance Dunham Joe Stiglitz OMB: Chris Edley Alan Rhinesmith Sally Katzen Alice Cho Jim Jukes WH Legislative Affairs: Paul Carey	A meeting at the Treasury Department regarding the regulatory consolidation proposal. Discussion topics included: supervision of state-chartered banks, possible advisory councils, funding for the proposed Federal Banking Commission, and possible briefings for various interest groups.

01/14/94	OCC: Konrad Alt Bill Bowden Julie Williams Jim Kamihachi John Carlson Eileen Gallagher Leonora S. Cross Treasury Representatives NEC: Ellen Seidman	A telephone conference call regarding items remaining to be accomplished and followed-up on.
01/14/94	OCC: Konrad Alt Julie Williams Brenda Curry Jim Kamihachi John Carlson Judy Walter Roy Madsen Tom Lantzas Wayne Leiss OMB: Alice Cho Alan Rhinesmith Others Treasury: Brian Mathis Gordon Eastburn Mark Bender OTS: Bernie Mason	A meeting at the OCC to discuss the various options for funding the Federal Banking Commission and a brief discussion regarding OMB's methodology for estimating the long-term savings from consolidation.

01/14/94	OCC: Jim Kamihachi David Nebhut Mark Winer Rich Nisenson Phil Bartholomew Thomas Lutton CEA: Constance Dunham Kevin Murdock	A meeting at the OCC to discuss the OCC's analysis on the number and size of banks and holding companies subject to supervision by various Federal regulators.
01/18/94	OCC: Gene Ludwig Konrad Alt Treasury: Rick Carnell Frank Newman Mike Levy Brian Mathis OMB: Chris Edley WH Legislative Affairs: Paul Carey NEC: Ellen Seidman	A meeting at Treasury to discuss the consolidation proposal.

01/19/94	OCC: Judy Walter John Carlson Roy Madsen Tom Lantzas Treasury: Gordon Eastburn OMB: Alice Cho Alan Rhinesmith OTS: Bill Durbin	A meeting at OMB to discuss the long-term budgetary savings associated with the consolidation proposal.
01/25/94	OCC: Stephen Steinbrink Konrad Alt Bill Bowden Jim Kamihachi Treasury: Rick Carnell CEA: Constance Dunham Joe Stiglitz	A conference call to discuss the examination procedures of all the federal banking regulators.
01/25/94	OCC: Tom Lantzas OMB: Alice Cho	A meeting to discuss the cost projection model associated with the regulatory agency consolidation proposal.

01/28/94	OCC: Bill Bowden Julie Williams Treasury Representatives NEC: Ellen Seidman DOJ: John Rogovin Others OTS: Carolyn Lieberman OMB,CEA	A meeting at the Old Executive Office Building to discuss resolution of outstanding issues in regulatory consolidation proposal, particularly independent litigating authority.
02/02/94	OCC: Brenda Curry OMB: Alan Rhinesmith Doug Steiger Peggy Kuhn Jim Jukes Gary Waxman Alice Cho OTS: Kevin Petrasic Dorene Rosenthal Jeff Miner Treasury: Roberta McInerney Peter Bieger Stephen McHale NEC: Ellen Seidman	A meeting, called by OMB, to discuss its views on the nonpersonnel issues contained in the Administration's agency consolidation bill.

02/07/94	OCC: Gene Ludwig Julie Williams Jim Kamihachi Treasury Representatives NEC: Ellen Seidman OTS: Jonathan Feichter OMB,CEA	A meeting at the Treasury Department to discuss resolution of outstanding issues in regulatory consolidation proposal. Comptroller Ludwig did not stay through the entire meeting.
02/07/94	OCC: Bill Bowden Treasury: Rick Carnell Frank Newman Peter Bieger Marybeth Triano OTS: Carolyn Lieberman DOJ: John Rogovin David Anderson John Dwyer Arthur Goldberg Anne Weisman	A meeting to discuss independent litigation authority as contained in the consolidation proposal.

02/10/94	OCC: Jim Kamihachi John Carlson Wayne Leiss Tom Lantzas David Nebhut Treasury: Rick Carnell Brian Mathis OMB: Alan Rhinesmith	A conference call to discuss the amount of fees the Federal Banking Commission would be required to charge in order to meet its costs.
02/15/94	OCC: Gene Ludwig Treasury: Rick Carnell Frank Newman OMB: Chris Edley White House Counsel: Joel Klein DOJ: Walter Dellinger NEC: Ellen Seidman	A meeting to discuss the removal authority issues raised by the consolidation proposal.

02/16/94	OCC: Julie Williams Judy Walter Treasury Representatives NEC: Ellen Seidman OTS: Jonathan Fiechter Karen Solomon Carolyn Lieberman OMB,OPM,CEA	A meeting to discuss resolution of outstanding issues, including administrative issues in the regulatory consolidation proposal.
02/16/94	OCC: Gene Ludwig Treasury: Frank Newman Rick Carnell NEC: Bob Rubin Ellen Seidman	A meeting at Bob Rubin's office to discuss the consolidation proposal.
02/22/94	OCC: Judy Walter John Carlson Roy Madsen OMB: Alan Rhinesmith Alice Cho OTS: Bill Durbin Bill Casey	A meeting at OMB regarding administrative issues concerning the consolidation proposal.

:4/94	OCC: John Carlson Treasury: Rick Carnell Brian Mathis OMB: Ken Ryder	Conference call to discuss the budgetary scoring issues regarding agency consolidation.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM JONATHAN L. FIECHTER

Q.1. In your testimony you asserted that the OTS is facing budget problems due to the continued shrinkage in the thrift industry. However, the Savings and Community Bankers Association contends that, despite these funding challenges, the OTS remains extremely viable with as much as $100 million in reserve. Please clarify the current funding reserve of the OTS and, if the SCBA contention is correct, please clarify what budget problems currently exist at OTS.

A.1. SCBA is correct that OTS has reserves.[1] As of year end 1993, OTS had a cash balance of $89.3 million. This is $5.9 million less than our cash balance at the beginning of 1993.[2] We are currently operating at a deficit, and our financial projections indicate that we will continue to do so for the next 3 years.

As the thrift industry shrinks, OTS revenue declines. The industry is shrinking both in terms of the number of institutions and the total assets they hold. At the end of 1993, the industry's assets had declined to about $804 billion, from $1.3 trillion in March of 1990. Even though we increased our assessment rate by 5 percent in 1992 and by 4 percent in 1993, OTS revenues have dropped from $228 million in 1991 to $184 million in 1993—a decrease of 19 percent over the last 2 years. Financial projections through 1996 project further decline. Industry assets are expected to drop to $778 billion, and OTS income to approximately $150 million.

To contain the size of the deficit to the maximum possible extent and to avoid imposing unreasonably high assessment increases on the industry, OTS has moved aggressively to cut its expenses. Because compensation and benefit costs constitute over 75 percent of our annual budget, staff reductions have become an inevitable consequence of our attempts to curb expenses to offset declining revenues.

OTS staff has declined by 46 percent since its high point in March of 1990—from 3,442 employees to 1,850 as of March 31, 1994. We expect to reduce the staff by at least another 8 percent in 1994. In addition, we have limited annual compensation increases. This year, the average salary increase was 2.45 percent. No bonuses were paid.

Thus far, we have been able to continue to fulfill our mission to ensure the safety and soundness of the thrift industry despite these massive staff cuts because we have fewer institutions to supervise and because the industry's performance has improved significantly. As of March 31, 1994, 99 percent of the industry met the FDICIA criteria for adequate capitalization and 93 percent of the industry was well capitalized.

Nonetheless, the process of reducing expenses through staffing cuts has been quite difficult for both management and staff. We

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[1] In the interest of greater clarity, we have discontinued using the term reserves and instead measure our financial condition in terms of our cash balance and our capital using generally accepted accounting principles (GAAP).

[2] At year end 1993, OTS's GAAP capital was $106.5 million. This number reflects the accounting requirement, set forth in Financial Accounting Standard 106, that we recognize a liability for life and health insurance for retirees. OTS has decided to terminate its current health insurance program, which will enable us to reduce this liability on a going-forward basis, but will not eliminate the liability for current retirees and near-retirees.

have used a variety of means (in addition to attrition) in order to achieve the necessary reductions, including offering employees financial incentives to retire or resign. In OTS regional offices, where the majority of our staff reside, we have found it necessary to use directed reassignments and targeted reductions in force (RIF's) in order to meet staffing goals and accomplish the consolidation of twelve district offices into five regional offices. It may be necessary to implement a RIF in our Washington headquarters as well.

I am particularly proud of the excellent work our staff has done given the agency's relentless downsizing. But our employees are understandably tired of coping with a constant, long-term uncertainty about whether they will continue to have jobs. Cutting staff by 10 percent or 12 percent every year will eventually take its toll on the quality of supervision we are able to provide. Staff with the kinds of skills necessary to regulate a sophisticated financial services industry are increasingly reluctant to remain at an agency that can offer them no job security, even in the short term. If the thrift industry continues to shrink at its present rate, the OTS could reach a point where the quality of its staff will deteriorate below an acceptable level. As I said in my testimony before the Committee, we simply cannot afford a repeat of the mid-1980's scenario of a weak, understaffed thrift supervisory effort.

Thus, I believe the essential question is *not* whether OTS can remain solvent. From a strictly financial standpoint, the agency is, and will remain, a viable entity in the near term. We have the ability both to continue to downsize and to raise assessments on the remaining OTS-supervised thrifts. The more compelling issue is whether we can continue to deliver quality supervision at a cost that the industry can afford.

BANKING INDUSTRY REGULATORY CONSOLIDATION

THURSDAY, MARCH 3, 1994

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met in room 538, of the Dirksen Senate Office Building at 10:10 a.m., Senator Donald W. Riegle, Jr. (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The Committee will come to order. Let me welcome all those in attendance this morning.

We're continuing with our series of hearings on consolidating the bank regulatory agencies. And this morning, we're pleased to welcome representatives of the American Bankers Association, The Bankers Roundtable, the Conference of State Bank Supervisors, the Independent Bankers Association, and the Savings and Community Bankers of America, all here to testify on this issue of regulatory consolidation.

I want to thank our witnesses for coming and say to each of you that your associations have been extremely active in criticizing our regulatory supervisory system over the past few years.

In particular, your representatives have correctly, I think, and aggressively pointed out to us the problems your industry faces with respect to the problem of duplicative examinations, duplicative applications, the duplication in State regulatory functions, and in other areas that you often face under our current supervisory regime.

Your representatives have also pointed out to us numerous other regulatory overlaps among our four Federal banking agencies. The regulatory consolidation proposal that I've introduced, together with Senator D'Amato, and the separate proposal which has been introduced by the Administration, are two good faith efforts to address your concerns.

I think it is highly unfortunate that the Administration's proposal has been miscast by some as an attempt to do away with the dual banking system, and that legislative efforts to consolidate the bank regulatory agencies to improve the overall efficiency of the banking system and to improve competitiveness have been mischaracterized by some others as a diversionary tactic. Nothing could be further from the truth.

Among the clearly stated purposes of our current efforts are the following:

We want to preserve and enhance the dual banking system. We're not going to produce anything here that would do otherwise.

We want to reduce the costs of regulating depository institutions.

We want to eliminate needless regulatory burdens, thus allowing insured depository institutions to compete more effectively and to better serve their customers.

We want to eliminate overlap, confusion, and inconsistency in the supervision and regulation of insured depository institutions.

We want to take better account of differences among insured depository institutions, and in particular, the differences between small, independent institutions, regional banks, and money-centered banks at the other end.

We want to eliminate unwarranted impediments to credit availability for business, including small business, which is a concern of mine and Senator D'Amato's. And also, we are concerned about the problem that consumers can have as well with availability of credit.

So I know of no better way to streamline and address some of the regulatory concerns that your various associations have brought to our attention than through our current efforts to carefully and meaningfully consolidate the bank regulatory agencies into an independent, Federal Banking Commission.

Now, I know, Senator D'Amato has stressed this point, and I want to stress it with equal fervor today. The Federal Banking Commission has to be independent and has to be constructed in such a way that there is no way now, or at any time in the future, as Administrations come and go and parties come and go, that there can be any way in which the independence of a Federal Banking Commission is put in question.

There are ways to design it to see that the independence issue is dealt with, and I want to make sure that any bill that comes out of here will deal with that in a way that is satisfactory to Senator D'Amato, myself, and this Committee.

I might say that John McCoy, who is the chairman and CEO of Bank One Corp in Columbus, Ohio, likens the current regulatory system to, and I quote him:

> Going for a physical and having four doctors.

Or Kevin Kelly, who is the president of the U.S. Bank Corp in Portland, Oregon, who has said:

> We sometimes felt like we were being reviewed every other week by regulators with very different agendas.

Yesterday here in this room, we heard from the Chairman of the Federal Reserve Board, Alan Greenspan, that he is in 80 percent agreement with the Administration on a proposal to consolidate the bank regulatory agencies. And we have asked him to work with Secretary Bentsen to see if we can't resolve the remaining issues and come to a common point of view on a proposal that will have the benefits that we seek and all the safeguards that we need.

So we have a unique opportunity to address this issue this year. And I want to just say to you, I think there's a lot to be gained for the banking system if we can do this and do it right. There are moments, legislatively, when you can accomplish things and you have to take those opportunities. The legislative window's open and there's a chance to do something, and then for any number of rea-

sons, legislative windows can close and a long period of time can pass before there's another opportunity to do it.

I think we have that window open now, and I think if we work closely together we ought to be able to take advantage of it in a constructive way, serve the public interest, strengthen our banking system, have something that's good for the customers and banks, and strengthen your competitive position.

With that, let me yield to Senator D'Amato and then I'll go to Senator Moseley-Braun.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Thank you very much, Mr. Chairman.

Let me say, I am not surprised, but I am heartened, by your remark about the absolute necessity for independence in the banking regulatory system.

Mr. Chairman, you and I have worked very closely together and we've joined together in legislation to make it easier for the banks of America to engage in their business, to reduce costs, paperwork, and unnecessary regulatory burden.

I don't think there's one Member of this Committee that doesn't share that objective.

Having said that, I have to say that it's about time that the Administration understand this. My confidence and the trust of the American people in the independence of these agencies was jolted last week by revelations about the White House interference with the RTC investigation of Madison.

And today, we learned from the Washington Post, that there have been at least two other previously undisclosed meetings between White House staff and Treasury at the RTC.

This time, the meetings were about the criminal referrals that were made to the Justice Department by the RTC. This is incredible and shocking.

Mr. Chairman, we had people who knew about these briefings before the Committee. They were here. When we asked Mr. Altman he said well, yes, he had one meeting. I find it hard to believe that no one knew that the General Counsel of Treasury was at two other meetings.

I want to know this: when there's a criminal referral, is it appropriate for the General Counsel of Treasury to go, or the Secretary's assistant or former assistant to go to the White House for a briefing? What was that about?

The action that Senator Dole and I and 41 of our colleagues took in sending a letter yesterday evening to the Majority Leader, Senator Mitchell, saying that we will not go forward with the Tigert nomination, as the head of FDIC, until and unless our request to have oversight hearings as it relates to these matters is granted.

We can have no confidence that she will head up this agency independently, given what we've seen today. Flagrant intervention, exercise of positions of power, and compromising independent agencies.

Mr. Chairman, in this climate of concern about independence, I was surprised to discover provisions in the Administration's bill that would make the proposed Federal Banking Commission literally a puppet of the White House.

As I pointed out yesterday, under the Administration's proposal, the Justice Department would have complete control over the new banking agency's litigation authority. Now think about that. That means, if this proposal is enacted, the FDIC in a civil action, let alone a criminal action, as it related—or criminal referral or civil, or the RTC, that they would have to get the Justice Department to sign off.

What kind of authority does that give to the independent agencies when the Justice Department people have all the guns and all the ammunition.

In addition to requiring Justice Department approval over all litigation, the Administration's bill would prevent the new banking regulator from even proposing a regulation, submitting testimony, or providing legislative recommendations without prior approval of the White House Office of Management and Budget.

What kind of independence is this? The Fed couldn't come in here and give testimony without it being cleared by the White House.

You know, if the Administration's bill were the law today, the RTC could not sue to recover money from anyone who defrauded Madison Savings & Loan without Justice Department approval. The FDIC could not testify about Whitewater without the blessing of the White House.

It's hard enough for the American people to learn the facts and be assured by the agencies that they are applying the laws impartially under the current law. But can you imagine if these agencies were directly under the political thumb of the White House?

How can we expect the American people to entrust Janet Reno to make decisions on bank litigation or how can we tell them that Webster Hubbell, himself under scrutiny by his old law firm, will make these decisions?

I believe in the need to consolidate bank regulatory agencies, as I've said to you, Mr. Chairman, but I believe more strongly in the principle of independence. And if the Administration does not agree with this principle, then I seriously doubt any legislation will emerge from this Committee.

If the Administration does agree, then I'd be encouraged by some of the comments of the Chairman and the Secretary of the Treasury. If their idea of independence is to put Janet Reno and Webb Hubbell and other Administration insiders in control of the Nation's banking system, I will fight them tooth and nail and this bill will not come out of Committee. It certainly will not pass on the floor, and there will be literally no support.

On the other hand, Mr. Chairman, I have to tell you that if we're talking about truly independent regulatory bodies, with the safeguards that are absolutely necessary, and that I believe you and I and our staffs have worked for, that's another matter. And I will join with you in working to see to it that we will relieve the banking industry of many of these unnecessary burdens, but under the supervision of strong independent agencies, without intrusion from the White House; be it this White House, or White Houses in the future.

Mr. Chairman, I feel very strongly about this. Senator Dole does. Forty-three other Republicans do. We must find out how it is that

the independence of regulatory agencies have been compromised. How seriously have they been compromised? It's difficult for us to ascertain.

That's why we need these hearings to find out just what was discussed. I'd hope that any memos, minutes, et cetera, that were taken will not be destroyed. That we not have documents lost, because I believe that in the fullness of time, we will get these hearings.

I believe that this is not the kind of thing that the political spin doctors at the White House are going to keep from taking place.

They can attack people who bring this up, they can attack the messenger. But in the final analysis, I believe the voice of the American people will demand, at the very least, that these hearings take place on who was called in, how did these meetings come about, and what was discussed.

Mr. Chairman, I thank you again for what I have known to be something that you feel strongly about—regulatory consolidation. Regulatory consolidation done the right way, guarantees the independence that I think every Member of this Committee will want to ensure.

I thank you.

The CHAIRMAN. Let me just say on the independence issue, my passion is the equal of your own on that matter. It's interesting because we're talking about changing it so that it has the effect in the future, through whatever succession of Administrations, and we had this issue come up before, even in the last Administration. There was a regulatory consolidation proposal then, and during the Bush period, and it was to put these functions under the Treasury Department.

It was clear then, for the very same points you make about independence, that that would not provide a sufficient degree of independence, and so that did not move forward because it had that very defect.

And I can give you an assurance, I think, that we will not produce a bill here that falls short in that area. We've got to have certifiable, clear cut independence built in in a way that ensures that you're going to have the ability for agencies to act and act without any question or concern about any other factor.

I'm confident we can get that done. I would just say plainly, even if you had not made those comments today, that my view is the same as yours on that point. And that is we would not produce a bill here if it could not address that issue properly. And I think we can.

We're of the same mind on that and I think that's the view of the Members of the Committee on both sides of the aisle. I don't view it as a partisan matter, I view it as a non-partisan matter and to keep any aspect of partisanship out of it. That's one of the ways we do it.

We want to do it right because we want to get the advantages of consolidation and streamlining and not having three different regulators in the same institution at the same time doing three different kinds of examinations against three different kinds of standards, and we've had that happen.

Yesterday, I raised the point of who's in charge of regulating derivatives. And there was a long silence at the table. We had all four bank regulators there. But it's clear that nobody has really taken the responsibility in this area.

These tough issues often get pushed off onto a Committee and then they can rotate through a Committee for years without resolution because there isn't a point of accountability or responsibility. And I think that's one area where the risks are growing, and our regulatory structure, to my mind, is not sufficient enough to respond to it.

So I want to make sure that we're designed to deal with future problems that may arise, as well as make sure we've done things that would handle problems we've seen in the past.

Senator Moseley-Braun.

OPENING STATEMENT OF SENATOR CAROL MOSELEY-BRAUN

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman.

I am pleased to be here this morning as the Committee continues, hopefully, its examination of proposals to reform our system of bank regulation.

We have a distinguished group of witnesses before us today, and I'm particularly pleased to see Dick Thomas, who is the CEO of the largest banking organization in my State of Illinois, the First Chicago Corporation. He will be giving the Committee the benefit of his insights into regulatory consolidation issues, and I certainly look forward, and I know the Committee looks forward to his analysis and recommendations.

Regulatory consolidation is in part about efficiency and reducing duplication and about improving accountability and regulating intelligently. But it also has a powerful influence on the ability of the banking system to meet the needs of our economy in general and people and businesses in particular. It affects the ability of the banking system to respond to changes in our economy and in the financial marketplace. It also affects the ability of the banking system to innovate and to respond to the needs of people, businesses, and communities.

And, of course, it's about ensuring the safety and soundness of our financial system and about ensuring that the regulatory structure we establish has the ability to quickly and effectively respond to any financial crisis that may arise.

I support the idea of regulatory consolidation. I think the change is necessary and that that change, in fact, is long overdue.

Having said that, I also think it is important to understand where our financial system is headed and what changes are needed in Federal policies to maximize the ability of our financial system to meet the needs of our economy and of our people. There's no question that the current regulatory system is showing the strain. It is forced to respond to change on an ad hoc basis without clear policy framework. And that is why I've introduced Senate 1744 to help establish that framework. That's the Commission bill, Mr. Chairman.

A framework based on meeting the needs of economy and of the users of our financial system. That does not mean, I believe, we should delay taking a first step on regulatory consolidation issues

now. But it is important to remember that if this Committee does act this year, our action will only be the beginning, rather than the end of the process.

There are new issues out there that our current regulatory system did not anticipate. For example, issues involving rapidly growing new products like mutual funds and, as you mentioned a moment ago, derivatives.

I also think it is critically important that our approach to regulatory consolidation carefully consider our financial history. It is very unlikely that if we were designing our regulatory system from scratch, we would design the structure that we have now. However, we are not designing from scratch.

The consolidation proposal we act on, therefore, should reflect our history, should build on the parts of our system that are working well, and should not in any way weaken the ability of our regulatory system to forcefully and decisively respond in any future financial crises that may arise.

I know that many Members of this Committee have urged the Federal Reserve, the Treasury Department, and all of the interested parties to sit down together and try to give this Committee joint recommendations that will resolve the controversies which have emerged over the last few months.

I strongly urge both Chairman Greenspan and Secretary Bentsen to sit down together personally and to give this Committee the kind of joint recommendations that will enable us to move forward with a proposal that represents a real consensus of views and that we'll enjoy the kind of strong, public confidence and support that is so necessary in this critically important area.

The CHAIRMAN. Thank you Senator Moseley-Braun.

Senator D'Amato, before we go to the witnesses, let me comment on the other matter you raised earlier.

I received a call last evening from Roger Altman in reference to the matters that you discussed, and he called to indicate that since his testimony here, he had learned of this other, earlier contact last year about which he'd had no knowledge prior to yesterday.

He was obviously troubled about it and he was calling to indicate what he had learned and asked that it would be acknowledged today. He was also intending to call Senator Bond, who had engaged him in questioning on that issue, to cover that matter with him. And I understand that he did talk to Senator Bond last night.

He has also, as you know, taken the action to acknowledge, in a sense, an err in judgment on his part, having had the other meeting which was the focus of the discussion here that day. And has recused himself. It's my understanding that, in effect, a directive has gone out that there is not to be any contact of any kind relating to this matter or other matters that might come up of this sort.

Obviously, that's an appropriate thing to do. It should have been done a long time ago. I would think that with respect to our hearing record it is still open. I think the questions you're raising are questions that obviously have answers. The answers should be provided. And when we have those, we can decide at that point what's appropriate.

But I think that the fact that steps have been taken to try to deal with that, I just mentioned to Senator Bond, prior to your

coming in, that I had received a phone call from Mr. Altman last night with respect to the fact that he had learned yesterday of an earlier contact by the Treasury Department, and that he was going to call you to discuss that with you. And I gather he probably did so last evening, to share with you what he had learned.

I think it is important that these issues be fully understood. There shouldn't be any doubt about what happened, nor should there be any doubt about the fact that contact of that kind not take place in the future.

Senator BOND. Mr. Chairman, let me just confirm that Mr. Altman did call me last night. He did explain to me that he had not, at the time, known of the two contacts made by the RTC in meetings with the White House staff. I appreciated that. I think there are a number of questions like that. We are still, I believe, some ways away from putting the whole story together. Maybe when we find out all the details, there's no problem.

But I think on an issue this sensitive, I have taken some time in this Committee to explore those questions because I think for public confidence in this process it needs to be on the record, we can make our judgments and everybody else can when it is on the record.

So I expressed my appreciation to Mr. Altman for getting back to me. There have been some other testimony by members of the Administration before us today that do not quite square with what I've heard previously. And I intend to follow up, at least to find out what happened. Whether, in fact, there was anything amiss or not, I do not know, but I have received conflicting stories on their testimony and other things I've learned elsewhere.

Senator D'AMATO. If I might, Mr. Chairman.

The CHAIRMAN. Let me just say, Senator D'Amato, then I'll yield to you, Mr. Altman has, as you know, asserted here that everything was, in terms of the actual information that was discussed and so forth, proper and straightforward. But I think you're quite certainly within your rights to want to have those questions asked and answered, and they will be.

Senator D'AMATO. Mr. Chairman, let me, because you very graciously have responded as it relates to attempting to satisfy the record, satisfy ourselves, and satisfy the American people, by suggesting we could submit, since the record is open, written questions to Mr. Altman. But it is obvious to this Senator that there are questions that go well beyond Mr. Altman and maybe go beyond his knowledge and his ability to answer.

There would be questions that, for example, would have to be asked of the General Counsel, Jean Hanson. How she could permit the Deputy Secretary to make the statement that he made, that there was only one meeting, when she was aware that there were two others.

Let me suggest and let it be known, I did not trap in this Committee and the Republicans did not trap Deputy Secretary Altman.

The evening before, I gave him a heads-up when I returned his phone call. I told him that tomorrow we would be asking about any contacts with the White House. That's why he had a statement prepared.

Now he probably conferred after I spoke to him, on the evening before his testimony, with his staff. And I'd be absolutely surprised if he didn't speak to his General Counsel. I can't believe that she would not have advised him—and if she didn't, they're playing it pretty fast and loose—that she had participated in at least two other meetings.

And I've got to ask the question, and I think it has to be asked, how was it that a meeting between the General Counsel and the White House took place as it related to a criminal referral?

That is absolutely unconscionable. What business was it of the White House, or Mr. Nussbaum? Was Maggie Williams there? Were the rest of the spin doctors there? This is incredible. We're talking about a possible criminal referral and here she is going over to brief them.

Now if they have their own lawyers, their lawyers can make contact with the various agency lawyers as is done with everyone else. But they didn't go over once—they went over twice. And this Committee was led to believe, I believe in fairness, that there was only one meeting.

Now there was Secretary Bentsen here while this testimony was coming out, and we learned from a newspaper account that apparently his now-assistant, formerly Mr. Altman's assistant, was at least at one if not both of these meetings. And yet nobody made an attempt to correct the record during that procedure.

There are too many questions that have to be asked, not of Mr. Altman, but of all of those who have participated at the meeting and now at least three meetings. And that is absolutely essential.

So while Mr. Altman may have given us his best information, it's obvious that Jean Hanson should be brought before the Committee. And, by the way, this will in no way impede the Office of the Special Counsel. We're attempting to find out how it is that these meetings were set up. We don't want to speak to any of the participants in Whitewater-Madison. We're not looking for documents. But we do want to know what, if anything, has been done by the White House to interfere with the independence of a regulatory body charged with ascertaining whether or not there is any kind of liability, civil or otherwise.

I think that's why, Mr. Chairman, the response that you gave to us did not go far enough. I appreciate that you said that if it fails to answer all of the necessary questions, you would then review it. But I thought I would share with you why 43 of my colleagues have felt that we have to go further, and there should be these hearings.

And I thank the Chair.

The CHAIRMAN. Gentlemen, you've been very patient, and I think we'll get started with our witnesses.

Did you have an opening comment you wanted to make on the substance of today's hearing?

OPENING COMMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Mr. Chairman, believe it or not, I have an opening comment that goes to the substance of the hearing.

[Laughter.]

I want to lay it out as a predicate because, this is a real change of pace, and I will ask questions based on this later on, to see if we're all playing on the same field. I appreciate your giving the issue of bank regulatory consolidation so much time. The hearings are helpful.

I think we are at the point where most witnesses agree on the following things. And I'd like to pursue this to see if we're all together on this point.

No. 1, the status quo is unacceptable.

No. 2, there should be no single Federal regulator.

No. 3, we must preserve the dual banking system.

No. 4, we must ensure political independence of the new agency.

No. 5, there should be one regulator per banking organization.

No. 6, the OCC and the OTS should be merged.

No. 7, the proposal must reduce costs and regulatory burden to the banking industry.

And No. 8, the Federal Reserve should maintain a role in banking supervision and regulation.

I think that most of the witnesses agree on these points. If you don't, I'd like to know where, and I believe the Fed agrees with most of the points and the Treasury agrees with most of the points. I think if we can narrow it down to find out which of those we disagree on, we can move forward, at least with some of those basic principles.

Thank you very much for allowing me the time for the opening statement.

The CHAIRMAN. Well, I think that's important. I appreciate those points.

We're going to start, and go right down the table. Let me introduce our witnesses and then we'll call them in order as we go.

Mr. Howard McMillan, Jr., who is here on behalf of the American Bankers Association; Mr. Richard Thomas, who is here on behalf of The Bankers Roundtable; Mr. James Gilleran who is here on behalf of the State Bank Supervision Conference; and Mr. John Shivers, who is here on behalf of the Independent Bankers Association of America.

Mr. David Holland was scheduled to be here today, but he is unable to be here and we have, in his place, delayed by the weather, Mr. Alfred Pollard, who is Director of Government Relations for the Savings and Community Bankers of America, and he will present Mr. Holland's testimony.

Gentlemen, what I'd like to do today, with your permission, is we'll make your full statements a part of the record, and I would like you to summarize, as pointedly as you can. I'm sure you've had some flavor of our earlier discussions.

I think what Senator Bond has just said is a very useful construction for today's testimony and questions and answers. And so to the extent that you can come in on those points, I think that would be very useful.

So, Mr. McMillan, we'd like to hear from you first.

STATEMENT OF HOWARD L. McMILLAN, JR., PRESIDENT AND COO, DEPOSIT GUARANTY NATIONAL BANK, JACKSON, MS, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. McMILLAN. Thank you, Mr. Chairman. I'm pleased to be here this morning to present the ABA's views on regulatory consolidation.

I congratulate you and Senator D'Amato for your leadership role in highlighting some of the problems that we face, and for providing us a forum for thorough discussion of these issues.

We look forward to working with the Committee, the regulators, and the Administration in finding a workable structure to improve and streamline the banking examination and supervision process.

There are a number of very thorny issues that must be addressed, a lot of problems that have to be worked out, and ABA's membership is willing to roll up its sleeves and really go to work on these issues with you.

Senator Bond, if we were to start from scratch to design a regulatory system, I am sure it would not look anything like what we have today.

Mr. Chairman, as you mentioned, I think we all agree that we would not have four Federal regulators examining the same banking organizations to see that they are in compliance with the same set of banking laws. This regulatory overlap means that banking organizations spend an inordinate amount of time sorting out and complying with the regulatory interpretations of different agencies. Between multiple safety and soundness and compliance exams, many bankers are inundated with large numbers of examiners all the time.

In addition to multiple exams, any actions that require regulatory approval, such as branching or acquisitions, are also complicated by the need to deal with multiple Federal agencies. I'll give you an example. My holding company is a two-bank holding company. We're examined by the Fed at the holding company level. We have two national banks that are examined by the OCC. And the FDIC comes in to review our deposit structure.

We have an investment subsidiary that's examined by NASDA, by the OCC, and the SEC, all three very much overlapping and redundant type examinations.

As I travel around the country in my role with the ABA, I talk to many, many small bankers who find this a very significant problem. They have large numbers of examiners in their banks back to back almost all the time.

One interesting situation was in a Midwest small bank, with 8 to 10 employees. They had two different groups of examiners in their bank at one time. Both groups were in there for about 3 weeks. They had to go to their local church to borrow chairs and tables to accommodate the examiners. The parking lot was filled with examiners' cars and customers couldn't get in to do business. So that's the sort of thing they're running into.

Maintaining four separate examination forces at the Federal level is an expensive exercise in redundancy. The difficulty and expense of having four Federal regulators negotiate virtually every regulation and guideline should not be under-estimated.

As you know, the banking industry pays the bill for its examinations. And as bankers, we have a strong interest in ensuring that the system be as efficient and cost-effective as possible.

While the current regulatory structure has many shortcomings, it also has many desirable features that work well and should be preserved. And as two of you have mentioned, first and foremost is the dual banking system.

This country has the most diverse and competitive banking system in the world, and the dual banking system is a key reason for this.

Many things that are commonplace in our banking system today are a direct result of innovations at the State level. NOW accounts, variable rate mortgages, even interstate banking on which this Committee, just last week, took a significant action, owe their beginning to State bank regulators.

Furthermore, improvements in examination techniques, examiner training, and bank regulations have resulted from the dual banking system.

Mr. Chairman, we do not believe the creativity of the dual banking system can survive with a single Federal regulator.

In addition to protecting the dual banking system, there are a number of criteria, some of which have been mentioned, against which any consolidation proposal should be judged.

The proposal must result in significant cost savings and less regulatory duplication. Consolidation of agencies must not lead to a merger of the Deposit Insurance Fund.

The proposal should include credit unions. Bank regulation and supervision should be as independent as possible from political pressures, and the relationship between banking and the Federal Reserve in promoting economic stability and conducting monetary policy should be preserved.

If banks are to fulfill their role as providers of credit and other vital financial services, they must be free to respond to market conditions. They must not be subjected to pressures of political credit allocation. We believe that an independent regulatory system is the best way to ensure that safety and soundness are not compromised.

We look forward again to working with this Committee, the regulators, and the Administration to identify ways in which we can make improvements in the existing regulatory system. We appreciate your leadership, and we'll be glad to try to answer any of your questions.

Thank you.

The CHAIRMAN. Very good. Thank you for your comments.

Mr. Thomas, we'd like to hear from you now.

STATEMENT OF RICHARD L. THOMAS, CHAIRMAN AND CEO, FIRST CHICAGO CORPORATION, CHICAGO, IL, ON BEHALF OF THE BANKERS' ROUNDTABLE

Mr. THOMAS. Mr. Chairman, Senator Bond, Senator Moseley-Braun, I am Richard Thomas, Chairman and CEO of First Chicago Corporation, headquartered in Chicago, and I'm appearing today on behalf of The Bankers Roundtable, which was formed in mid-1993 by the merger of the Association of Reserve City Bankers and the Association of Bank Holding Companies.

The Roundtable membership is composed of the Nation's major banking companies. The membership is composed of the highest ranking executives of those companies, and our member companies hold approximately 70 percent of the Nation's commercial deposits and employ almost 1 million people.

I will summarize my comments in light of the earlier discussion.

First Chicago Corporation is subject, as a holding company, to the regulation and supervision of the Federal Reserve Board through the Federal Reserve Bank of Chicago.

Two of our largest subsidiaries are national banks, regulated and supervised by the Office of the Comptroller of the Currency. The third subsidiary is a bank holding company supervised by the Fed, with banking subsidiaries supervised by the OCC. All these banks are also subject to supervision by the Federal Deposit Insurance Corporation which insures the deposits they maintain.

In addition, we are involved in several other businesses which, because of banking law, must be conducted through nonbanking subsidiaries and these are regulated by a variety of other regulators.

As the Chief Executive Officer of a large and diversified banking company, I obviously have a keen interest in the issue of bank regulatory reform. As important as this issue may be, however, the issue of fundamental and comprehensive reform of the banking system itself is even more important. And that issue should logically be addressed before any reform of the bank regulatory structure is undertaken. But having said that, it's clear that the current bank regulatory structure is unnecessarily complicated, redundant, and duplicative.

The membership of The Bankers Roundtable believes that there are changes that can and should be made to streamline the Federal banking regulatory and supervisory system and make it more responsive to the regulatory and competitive challenges facing banking today. And we believe this can be done while still maintaining the safety and soundness of the system.

The Bankers Roundtable believes that, as with interstate banking, the time has come to reform our Federal banking regulatory and supervisory structure. Consequently, the Roundtable seeks to work with the Committee, with the Administration, and with the banking regulators to develop a workable plan.

Reform of the regulatory structure is important for two major reasons. First, we believe reform can and should give the Federal banking agencies the flexibility to adapt to the changes underway in the marketplace, and to facilitate a much needed modernization of the banking industry in the near future.

Second, reform of the bank regulatory system is an important step because there has been a virtual explosion in compliance requirements where banking dictated by laws, such as the Financial Institutions Reform, Recovery, and Enforcement Act in 1989, FIRREA, and the Federal Deposit Insurance Corporation Improvement Act of 1991, FDICIA, we are literally drowning in paper work, forms, and reports flowing from these laws that serve no useful purpose but which add tremendously to the cost of doing business.

As a first step toward reshaping the current banking regulatory and supervisory structure, The Bankers Roundtable has established a set of principles that reflect our memberships' concerns and objectives.

And by the way, Senator Bond, we totally agree with the 7 or 8 or 9 points that you made earlier; total agreement on that.

I've already stated our first principle, which is that the status quo is unacceptable, and that we welcome this effort by the Committee to craft a new structure.

Second, the Roundtable believes that significant administrative efficiencies can be achieved through regulatory reform, and we hope that it may be possible for all of the parties involved, the Congress, the Administration, the regulators, and the industry, to work together to find ways of achieving these efficiencies. And our Roundtable looks forward to participating in that process.

Third, we believe that reform of the Federal banking regulatory and supervisory system should lead to reduced costs in banking regulation, while improving the effectiveness of the bank regulatory and supervisory system.

Fourth, we believe that the Federal banking regulatory and supervisory system should be revised in a way that ensures an appropriate balance between the surviving Federal agencies and our system of State and Federal regulation.

Fifth, we think there should be a continuing role for State bank supervisors, for the Comptroller of the Currency or a new successor Federal Banking Commission, and for the Federal Reserve.

And finally, as per the discussion this morning, we believe very strongly that any new bank regulatory agency, in both its design and its operation, should be insulated from political forces to the maximum extent possible.

The Bankers Roundtable commends to the Committee Members these important principles, which I think are consistent with those that were enumerated earlier by Senator Bond.

With the principles that we have outlined in mind, I'd like to address their implications for some of the key elements of the regulatory reform proposals now under consideration.

First, like others, we think it is clear that the Office of Thrift Supervision should be merged with the OCC, to form a new independent Federal Banking Commission. Indeed, we believe there is near if not complete unanimity on the desirability of this step.

There should not be a merger, however, of the Bank Insurance Fund and the Savings Association Insurance Fund.

Another step we think that clearly is desirable and we think most others also recognize to be desirable is the removal of the FDIC from its current role as primary Federal supervisor of State nonmember banks. This would eliminate the inherent conflict of interest that the FDIC currently faces as both a regulator and an insurer.

The FDIC's regulatory and supervisory authority should be reduced to back up authority in troubled or failing institution.

In moving beyond these initial two steps, however, we recognize there is less agreement on what should be done to restructure the regulatory process. Nonetheless, there may be some additional

areas where real progress could be made and where agreement may now be achievable.

Clearly, duplication and redundancy of examinations by regulatory agencies should be eliminated. A logical step in this direction would be to ensure that each bank holding company and its subsidiaries be primarily responsible to only one Federal banking agency with examination and supervisory authority.

The appropriate roles for the principal Federal banking agencies, as well as for State agencies, also need to be addressed. These matters, however, are highly complex and require careful analysis, given the nature of the U.S. system of State and nationally chartered banks and all of the history that is behind that.

We believe there should be a continuing role for both the Federal Reserve and a new Federal Banking Commission in banking regulation and supervision. The Federal Reserve should retain its current role as the rulemaking authority for the bank holding company. The Federal Reserve should also have regulatory responsibility for a sufficiently large number of representative banks to enable it to carry out its roles in monetary policy, the economy and the payment system most effectively.

Finally and certainly not to be ignored in the present debate is the crucial issue of a single Federal regulator. Our membership feels very strongly that there are major problems and disadvantages of such an approach. We think other steps could be taken short of that which would represent real progress, real progress we should be able to make now, and I hope we do.

Finally, while the Roundtable's members are anxious to see progress made in the area of regulatory consolidation, we believe, as noted earlier, that an even more important step is the modernization of the basic laws under which our Nation's financial institutions operate.

As is the case with our current regulatory structure, these laws were crafted at another time to address another set of problems. Just as our regulatory structure is out of date and ill-suited to today's marketplace, so too are the Bank Holding Company Act and the Glass-Steagall Act.

We would hope, therefore, that the Committee would not lose sight of the need for appropriate changes in our basic banking laws. For example, we would urge the Committee to streamline the procedures for bank holding companies to engage in new, nonbanking activities, to create a standard for permissible nonbanking activities that acknowledges the integration of financial markets that has taken place, the impact of technology and new competitive realities, and to revise the cross-marketing rules to enable institutions to market products and services more efficiently and effectively to customers.

Thank you for the opportunity to appear here today.

The CHAIRMAN. Thank you, Mr. Thomas.

Mr. Gilleran.

STATEMENT OF JAMES E. GILLERAN, SUPERINTENDENT OF BANKS FOR THE STATE OF CALIFORNIA, SAN FRANCISCO, CA, ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. GILLERAN. Thank you, Mr. Chairman, Senator Bond, Senator Moseley-Braun.

I am Superintendent of Banks for the State of California, but today I am representing all of the superintendents and commissioners in the United States as Chairman of the Conference of State Bank Supervisors. CSBS is the professional association of State officials that charter, examine, supervise, and regulate nearly 7,700 State banks.

State banks continue to lead other types of depository institutions in all measures of safety and soundness, such as capital ratios, and they also have lower failure rates. State banks have an aggregate capital ratio of 8.14 percent. This rate compares favorably to the 7.8 percent capital ratio of national banks.

Only 41 banks failed in 1993. Failed State banks made up 18 of this total. This brings the failure rate for State banks below the ¼ of 1 percent mark, the lowest it's been in 10 years. We have no reason to believe that the downward trend in State bank failures will not continue.

Throughout the turbulent 1980's, fewer State banks failed and those that did fail cost the FDIC less then their federally-chartered counterparts.

The current Treasury proposal to restructure the Federal banking agencies will destroy the dual banking system. For this reason, CSBS is opposed to the proposal in its current form.

We've reviewed the changes offered by the Treasury Department earlier this week. While we believe that these changes were a good faith effort to address some of the States' concerns, they do not address the central flaws of the plan.

The main feature of the Treasury plan is a single Federal regulator for all banks, both national and State. The plan places the Federal oversight of State-chartered banks with the same agency that charters and regulates national banks.

We are concerned that the institutional bias of the Federal chartering agency will eliminate all the flexibility inherent in the State banking system. We do not believe there is an effective legislative or structural protection against the Federal chartering agency preferring the institutions it charters over State institutions.

If State banks are subjected to Federal oversight by the same agency that charters national banks, the viability of the State bank charter will be eliminated and the dual banking system will cease to exist.

This feature of the Treasury plan violates the first of the 7 criteria that CSBS identified that any restructuring plan must satisfy if the dual banking system is to be preserved. We've outlined all 7 in our written materials.

In the interests of time, however, I'd like to highlight 2 of the 7. It is important to note that all 7 are equally important. Any restructuring plan must meet all 7 criteria or it will severely damage the dual banking system.

Any new regulatory system must not impose new fees on State-chartered banks. Currently, both State banks and national banks pay two fees. The first is a fee to the respective chartering agency. The second is deposit insurance premiums paid to the FDIC. Any new regulatory scheme must not result in an additional fee on State institutions. This new fee is simply a discriminatory tax on State chartering.

Also, any new regulatory system must provide real choice between State and Federal charters. In order to maintain the benefits of the dual banking system, the decision of what charter to operate under must entail the weighing of different advantages and disadvantages.

If the exact same rules apply, and are administered by the exact same agency, no choice exists. The same rules also mean a one-size-fits-all approach that does not take into account the vast differences in local needs. Without a real choice, the dynamic that provides innovation in supervision and acts as a check on excesses, is destroyed. The State charter will be in name only.

Protecting the dual banking system should be one of your key objectives in any restructuring issue and I'm delighted to see that it is in yours, Senator Bond. It is the one issue on which everyone agrees, we think. What is it about the dual banking system that makes it so important? We believe it is the orientation of the State banking system on the needs of the local communities.

Job creation and economic development are critical issues in virtually all communities. States can be more responsive and flexible in meeting local needs for credit and other financial services. This produces innovations in both bank services and supervision that can be incorporated in other States or nationwide, if needed.

In addition, the majority of State banks are community banks. This allows State regulators and other policymakers to focus on the ability of community banks to meet the needs of small business and to help foster economic growth.

Another critical objective for any restructuring proposal is protecting the deposit insurance system. The Treasury plan, and most of the other restructuring proposals being considered, results in a significant reduction in the role of the FDIC in examining and supervising banks.

This reduction in the FDIC's current role and this responsibility under a new structure requires careful study. We are concerned the role of the FDIC has been lost in the debate of the other issues surrounding regulatory restructuring.

Due to a variety of circumstances, the FDIC may not be in a position to be as effective or at least as loud an advocate as the other interested parties in this debate. Having just survived a substantial threat to the solvency of the Bank Insurance Fund, it would be a tragedy to place the deposit insurance funds at risk in an effort to clean up an organization charter.

The taxpayer must ultimately bear any mistake made in reducing the FDIC's authority. Because of the situation at the FDIC, and the potential direct impact on the taxpayers, it falls to the Members of this Committee to put more emphasis on this question. We urge you to study the impact of reducing the FDIC's role carefully and to act with great caution.

In considering restructuring the Federal banking agencies, it is important to keep in mind that bank regulation is unique. The power of bank regulators exceeds that of Government officials that regulate other industries.

In many cases, the due process protections that shield other industries from regulatory excess are not present in bank regulation. The absence of these protections requires another mechanism to prevent abuse. Providing a real choice between bank charters is, in our opinion, the best substitute.

CSBS urges you not to adopt a restructuring plan that will damage the dual banking system. We believe that the Treasury proposal, with its single Federal regulator, is badly flawed and will undoubtedly achieve this result.

We appreciate the time and effort you have dedicated to this issue of restructuring and urge you to continue to strive for a workable restructuring plan.

Thank you.

The CHAIRMAN. Mr. Shivers.

STATEMENT OF JOHN SHIVERS, CHAIRMAN, PRESIDENT, AND CEO, SOUTHWEST BANK, FORT WORTH, TX, ON BEHALF OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. SHIVERS. Thank you, Mr. Chairman, Senator Bond, Senator Moseley-Braun.

I am chairman and president of Southwest Bank in Fort Worth, Texas. I'm also President of the Independent Bankers Association of America. We appreciate the opportunity to testify.

There are three basic problems from your eight, Senator Bond, that we particularly want to be used to evaluate any proposal.

They are the preservation of the dual banking system, the preservation of the Federal Reserve's role in bank regulation, and the preservation of a choice in regulators.

The single agency approach would imperil the dual banking system. A single, monolithic Federal regulator that is also the charterer of national banks would have a built-in bias toward national banks and against State charters and the innovations they have brought. This would destroy the dual banking system.

The Federal Reserve needs to remain a bank regulator for several reasons. Most importantly, having two hands-on regulators preserves vital checks and balances. Having a single, unchecked regulator can lead to catastrophic results. This was clearly illustrated by the way in which the Federal Home Loan Bank Board handled the S&L debacle.

Second, it is critical that the Federal Reserve regulate banks of all sizes. Our banking system is made up of vastly divergent sizes and types of banking entities. If the Fed does not have access to all sectors of the banking industry, it will not have a hands-on grasp of the whole economy, and will be unable to properly carry out its role of monetary policy.

For example, most community banks are involved in agricultural lending or are situated in areas where the local economy is heavily tied to agriculture. The Federal Reserve gets critical information about the agricultural economy from these community banks that is not readily available elsewhere.

Third, when banks become too risk adverse because of fear of regulatory action, a credit crunch is induced. Because a monolithic Federal regulator would have a narrow point of view with regard to its duties, i.e., safety and soundness, and since it would have no broader economic responsibilities, it would tend to push for too little risk in the system.

The Federal Reserve, because it also has macroeconomic responsibilities, must balance the risk with the need for adequate credit.

Fourth, the Federal Reserve needs hands-on experience and interaction with the banking industry to effectively manage monetary policy and deal with financial crises. This requires much more information than the financial condition of a bank at a particular point in time. The Federal Reserve knows how individual banks operate in the marketplace, what they do, and how the Fed can work with them to reach the necessary results.

Proponents of a single regulator criticize delays when the banking agencies work to adopt uniform rules. However, having more than one regulator brings innovation, new and diverse ideas, and a flexibility to consider alternatives.

The preservation of choice in a Federal regulator is important for banking. Banks cannot and should not be allowed to change regulators to escape enforcement actions. The issue is not allowing banks to choose the most lenient regulator; it is giving banks the option to deal with the unreasonable and bad regulator.

Single regulator advocates say that there are single regulators for all other industries. This argument ignores the fact that banking is the only industry where Federal regulation is so pervasive as to affect all aspects of the business and where the Federal administrative enforcement power is so pervasive and powerful. Members of his Committee probably do not fully realize the power that regulators have over banks.

The Nation's governors agree with the IBAA on this important point. Governor Branstad of Iowa, writing on behalf of the Nation's governors, has written that "any legislation should allow for banks to make a choice as to which Federal regulator is in their best interest."

There are overlaps and inefficiencies in the current system. The enormous overregulation in the current system will only be resolved if Congress changes the laws triggering this overregulation. Congress does not have to create a single Federal Banking Commission to provide that every banking institution should be examined by only one Federal regulator.

The IBAA believes that the only regulatory consolidation that is necessary and should be undertaken is the merger of the OTS and the OCC. Unfortunately, no powerful voice has urged the maintenance of an FDIC with a substantial primary examination authority over State-chartered banks. We still hope that an FDIC champion will emerge on this Committee. Until this happens, we are talking about a two-regulator system at the Federal level.

The Administration's proposal would have the Secretary of the Treasury on the Board of a monolithic Federal Banking Commission. This would inject the political process much too deeply into the bank regulatory process. The terms of the Board members are

too short and too close to the terms of the President to ensure meaningful independence.

If this Committee does authorize a Federal Banking Commission of more limited scope, we strongly recommend a board with a different structure and substantially different terms.

In conclusion, I'd like to say that there is merit to considering some changes in the Federal bank regulatory scheme. However, any changes should be made in consonance with the IBAA's three main principles. The preservation of the dual banking system, preservation of the Federal Reserve's role, and preservation of choice.

To act otherwise raises the real possibility of seriously harming the safety and soundness of a system that has served this country and its citizens well for a long period of years.

The diversified regulatory structure of the United States mirrors the diversity of the industry. A consolidated regulatory system would lead to a further consolidation of the industry. We should not emulate other regulatory systems, such as Japan, Germany, Canada, and the U.K., which all have vastly different and consolidated banking structures.

I thank you, Mr. Chairman, and I'll answer any questions.

The CHAIRMAN. Mr. Pollard.

STATEMENT OF DAVID F. HOLLAND, CHAIRMAN AND CEO, BOSTON FEDERAL SAVINGS BANK, MA, ON BEHALF OF THE SAVINGS & COMMUNITY BANKERS OF AMERICA, AS MADE BY ALFRED POLLARD, DIRECTOR OF GOVERNMENT RELATIONS FOR THE SAVINGS & COMMUNITY BANKERS OF AMERICA

Mr. POLLARD. Thank you, Mr. Chairman.

I'm Alfred Pollard, Director of Government Relations for the Savings & Community Bankers. I apologize that Mr. Holland could not be here, but the weather in the northeast made that impossible today.

Thank you for the opportunity to testify and for your leadership in this important area, and I welcome the opportunity to appear before you and Senator Bond and Senator Moseley-Braun.

Our position, at the outset, is that SCBA supports bank agency restructuring. Whether a merger of the OTS and the OCC or broader consolidation, legislation must address more than a mere administrative merger. Greater specifics need to be provided to support such a change.

Key elements of restructuring must include specificity on regulatory independence, impact on the dual banking system, demonstrable cost savings, and maintaining professional expertise dealing with diverse charter types.

Focused, professional, cost-effective supervision in a regulatory framework that recognizes the new competitive environment are essential goals.

In reviewing proposed changes, the Congress I know is aware that much of the regulatory burden is grounded in the law, not just the independent action of regulators.

U.S. banking needs law and regulation geared to the 21st Century, not just to the Depression era. The law must be consistent with the needs of a banking business that is confronting new and

more potent competitors, foreign and domestic, many of whom are unregulated or less regulated, and many from overseas.

This is taking place in a far broader economic and geographic environment than that for which the current system was designed.

SCBA finds the various proposals, such as S. 1633, H.R. 1214, the new Administration proposal, and the Federal Reserve's extensive comments yesterday to be valuable starting points for discussion.

It is SCBA's position that a number of questions should be answered in order for us to endorse any of the current initiatives. We look forward to working with this Committee in that goal.

Moving to a single regulatory framework, if presented in isolation, would not have the support of SCBA because standing alone as an administrative merger, the measure does not provide enough substantive relief to merit disruption of the current system.

SCBA supports a comprehensive approach that addresses all insured depositories, and I see no rational basis for failing to include supervision of the Nation's 12,000 credit unions who are marketing a full range of banking services.

Our overall concepts are as follows:

SCBA supports Federal regulatory restructuring that addresses the basic issues of differing legal regimes, accounting, examination and enforcement approaches, high overhead costs, and produces a streamlined, competent and efficient regulatory structure and staff.

SCBA will support regulatory restructuring that does not diminish the dual banking system and, indeed, banking agency restructuring should be an opportunity to enhance the strength and utilization of the flexibility and resources of State-chartering authorities.

Finally, SCBA feels that an independent regulatory structure, removed as much as possible from short-term political considerations, is in the best interest of the financial system.

For our membership, Mr. Chairman, the impetus for action is twofold. One is the status of the Office of Thrift Supervision, and the other is one of premium disparity.

First, it is clear that the Office of Thrift Supervision faces a funding challenge. While there are problems, OTS remains viable and appears to have as much as $100 million in reserve.

SCBA welcomes review of an OTS/OCC merger that meets with long-term goals set forth above. In line with our earlier views, consolidation limited to these two agencies still must be undertaken with consideration of more than just an administrative merger.

Attention must be paid to consolidation of legal, accounting and examination functions as well as differential regulation under such a new structure where different charter types coexist within the same regulatory jurisdiction.

The OCC has not had experience with saving institution charter forms, given its intense focus on the national bank charter, nor would a Federal Banking Commission have had experience, as does the FDIC, with State-chartered banks.

Second, and far more significant in dollar terms to our industry than any savings from regulatory restructuring is the looming premium disparity between BIF and SAIF insured institutions.

The Committee is familiar with this issue of a substantial disparity which would affect the availability of credit and its pricing,

which was raised during the recent RTC funding legislation and in recent responses to questions from the FDIC nominees. This disparity is detailed in my written testimony. And Congress should ensure that any restructuring proposals do not adversely impact or delay consideration of this critical issue.

SCBA believes that S. 1633, by the Chairman and Senator D'Amato, provides the vehicle necessary to advance regulatory restructuring. The key now is to provide additional substance to the proposal. The bill's call for a Federal Banking Commission, basically provides for an independent regulator, and SCBA fully supports this objective.

SCBA would welcome discussion of improvements, such as the Administration proposal for someone experienced with State regulation to sit on the Commission Board.

SCBA notes that the Administration and the Federal Reserve and following your admonitions yesterday, continue to discuss the role of the Board. SCBA feels it would be prudent to permit the Federal Reserve to retain supervision over large bank holding companies involved in the payments system in a significant way, and which are active players in the monetary process, particularly as primary dealers.

As to the dual banking system, SCBA urges the Committee to look to explicit enhancements in the role of State-chartering agencies while retaining clear Federal oversight, such as where the Government must protect insurance funds.

We support stronger Federal endorsement of the role of State-chartering institutions. Deposit insurance concerns should not impede the full utilization of State supervisory resources and avoidance of costly and duplicative Federal intervention. Some specific suggestions are in my written testimony.

Funding—How the Banking Commission will be funded obviously is of interest, both in absolute terms of costs, and as well as the impact on different charter types and on the dual banking system. We recommend further clarification of the funding mechanism and suggest that the possible route of FDIC providing for examination expenses be given consideration.

An item which has not been mentioned extensively, but is very important to SCBA, is the item of personnel and retention of professional expertise. SCBA members value a well-trained, stable, and professional regulatory staff. Expertise built up over years of dealing with different charter types should not be lost in a restructuring.

The retention, in addition, of personnel familiar with different charters must be part of reorganization planning.

And finally, on single versus multiple regulators, SCBA would reserve judgment for now for the reasons provided.

We look forward to working with you as you continue evolution of this proposal and answering many of the questions that were produced both by this Committee and by Senator Bond today.

Thank you.

The CHAIRMAN. Gentlemen, thank you for your comments.

I want to review our recent history and weed through what all of you've been saying in one degree or another. And I want to address this, Mr. Thomas, to you, as much as to anybody at the table.

I was thinking, as you were talking, where did FIRREA come from? It just didn't arrive on a space ship from another planet. It was the result of the savings and loan collapse.

It's interesting, if you go back and look at the savings and loan collapse, which a Federal Thrift Commission did, a group of impartial people looked at it, and they found multiple causes. Part of it being the interest rate mismatch problem with fixed mortgages and the spike up in interest rates in the early part of the 1980's.

But interestingly, and I want to have you really focus on this fact for a minute, and you particularly, Mr. Gilleran, after we finished working through that problem, and the S&L bailout, standing behind the Federal Deposit Insurance pledge is going to cost, in direct dollars, about $125 billion. That's without the interest. You throw those in on top, and this number gets much, much larger.

However, for the moment let us work with $125 billion figure. As we got into it, it turned out that 70 percent of the $125 billion, came from State-chartered institutions in two States; Texas and California.

But, what's interesting to me, and as we went through the difficulty of figuring out how to respond to the problem, and taxpayers who were irate to find out that all of a sudden they were on the hook for a $125 billion check that had to be written, it was because the State charters in two States became so expansive. Expansive charters that were based on the foundation of Federal deposit insurance, that when those charters did not work out properly, and there were major losses to be taken, the losses were not covered by the States who granted the powers; those losses were passed right through the States up to the Federal level and right into the Deposit Insurance Fund. And because the insurance fund was quickly made insolvent, you had a situation where taxpayers had to step in.

We have had a recent experience where State-chartered institutions relying on Federal deposit insurance got off the reservation to such an extent that it caused far and away the lion's share of the losses in the savings and loan system. In fact, I would characterize it this way. If you could take that part of the problem away, if you could subtract out that 70 percent of the problem, you'd have a problem of a very different magnitude. Still a big problem, but at least one or two or three orders of magnitude less.

So we thought about that for a long time as we crafted FIRREA. How do we preserve the dual banking system? Because I think it's valuable, I think it needs to be there, and we want to have it, and our bill attempts to preserve it. We're going to make sure we do preserve it with the bill that finally comes out of here.

But how do we handle the anomaly of State charters if we take the savings and loan case where two States went so far that they, in effect, almost singlehandedly broke the national system? Should we disconnect Federal deposit insurance?

Maybe the States ought to insure for charters that are qualitatively different than the Federal system. I mean, you can start to see the problem. A problem of wanting it both ways, by saying, leave us alone to do what we want to do at the State level, however broadly or narrowly, but nevertheless, we want to be in the Federal Deposit Insurance system. And if something goes haywire, don't

look to us, the States, to cough up the money to fix the problem even in our own State boundaries.

I can tell you this. If Texas, for example, had had to pay roughly 50 percent of the cost, which is what they're responsible for in the savings and loan losses, for the State-chartered institutions that went down the drain in their State, I don't know what they would have done. They would have gone into insolvency and they'd be paying for this for the next 150 years.

Some people feel that they should have taken the responsibility for that. That, in fact, this was an accident waiting to happen and it did. And why should the Federal taxpayer be the person who pays for the mistake in judgment by the State-chartering institutions in Texas.

It's a fair question. It's one of those questions that sort of defies a single answer today, looking back on it.

Interestingly, in the banking system, the State-chartered banks actually have a better record than the federally-chartered banks, if you look at the problems radiating through the banking system.

So you've got overlapping and adjacent time periods, experiences that are quite different. Again, as you try to draw a policy lesson out of this to say, well, wait a minute, how do we want to structure this system in the future so we get the pluses and not the minuses.

We want to be able to have enough latitude and flexibility at the State level for the dual banking system to work. If somebody comes up with a concept of NOW accounts or things of that kind, we want to have enough latitude so that we can make these product adaptations and develop these things.

On the other hand, I can tell you this. Just sitting on this Committee and representing the country, I don't think the Federal taxpayers want to write another check for $125 billion when some part of the financial system goes in the tank because somebody was asleep at the switch.

Because either the State charters were excessive in some cases, or the regulatory apparatus was too slow to respond, or there was too much forbearance for too long, and then all of a sudden everybody wakes up and there's a gigantic problem.

I would say that problem is even haunting the banking system right now. I would say that there are elements of FIRREA that you may find onerous that in part are born out of the experience of the S&L situation, because that was a very costly problem. And I think we really have to learn from it. We have to learn from it in terms of figuring out how we take that experience while it's still fresh and bring it into this banking consolidation effort.

Now the question of whether there should be one regulator or two is a very important question, because we're sort of trying to think that one through. You all have thought about it and you've brought your position here today.

You can also see some of the problems in that question. That by regulator shopping you can get a competition of laxity. You can also get a certain amount of conflict.

For example, we don't have two SEC's. If you want to go out and raise money in the securities markets as a public company you go to the Securities and Exchange Commission. We've managed to

structure that over time in a way which seems to meet the needs of the country.

We've got very innovative financial markets. They're thought to be probably the most innovative in the world today. But there's a single regulator.

Now you can argue how that's structured and the number of members and the length of the terms and so forth. But, you know, one might say, well, if you've got to have two bank regulators, why shouldn't we have two SEC's?

Or take the Federal Communications Commission. Is one enough or should we have two? If we're going to have two, well, why not 5 or 7 or some other number. I mean, is there something magic about having the two or a combination of something more than one.

There's a study that's been done by an outfit called Towers Perrin, and they did a survey among banks, very interesting the way they've done this survey, because they surveyed bank CEO's, and then they surveyed bank board members, and they got some interesting differences in responses, depending upon who's where in a banking organization.

But one of the interesting questions that they asked was a question with respect to how many regulators should there be. In the analysis and study that they did, they did this in 1993, they're an international consulting firm currently serving 587 financial institutions, and in their survey, where they asked CEO's and bank board chairmen and directors of U.S. banks with assets of $1 billion or more, whether they believed the regulatory jurisdiction should be rationalized and integrated into a single, well-managed structure, the numbers came back that 66 percent thought that that should be done. That there should be a single regulator as opposed to two regulators. But is that the critical difference that we're left with here? Does that matter, whether we have one or two?

It sounds to me like on most every other question, in terms of having a regulator that would go from top to bottom in a banking organization, the other things that are on Senator Bond's list are things we've tried to build into the legislation. Essentially, I think we're pretty close to an answer here if we can somehow work our way through the question of whether we need two or one in the way of bank regulators.

I'd like a brief comment and reaction to that from any one of you.

Mr. GILLERAN. Yes, Mr. Chairman. As far as the savings and loan losses are concerned, I share your desire, as a taxpayer, not to go through it again. I must tell you that in California and in Texas——

The CHAIRMAN. And I should say—let me just interrupt—you took over in California in 1989. I was looking at your background here, so I want to say that for the record. You were not the fellow in charge during the period of time that most of that was happening. So the record will reflect that.

Mr. GILLERAN. Thank you very much. That shows your fairness to point that out.

However, I'd like to point out that in neither Texas nor California, was savings and loan supervision ever part of the organization that supervised the banks. Banking regulation, both in Texas and

in California, and across the Nation, as far as the States are concerned, has always been different in the savings and loan industry.

One of the major differences is the fact that you had a single regulator in the savings and loan industry that was also the insurer. That set a pattern of very bad practices, including the establishment of regulatory accounting principles that were so vastly different from generally accepted accounting principles that these savings and loans were made to look like they had equity when they had none.

So at the root of the problem—and I agree with you that the problem is complex and there were many causes—but that was a major cause to have this one monolithic regulator. I think it should be instructive to use what happened there in the guidance for what to do in the banking industry.

As far as your comment on two SEC's, I think that also is something I'd like to react to, because of the fact we really have over 50 SEC's. Every State has its own Blue Sky Laws. Every State has the right to grant the issuance of securities.

The CHAIRMAN. Well, that's true in banking today too.

Mr. GILLERAN. That's right. I am the Securities Commissioner for State banks in California, and I grant the permission to sell securities. So we have many different SEC's in this country.

The CHAIRMAN. But you do in banking as well. I mean, that the substructure is roughly equivalent on both sides. The question is in terms of a Federal regulatory structure, do you need two, or can one do it, or do you need some number greater than one?

The SEC has found that it can function on the broad national level with one.

Mr. GILLERAN. As Chairman Greenspan pointed out yesterday, there are many organizations that relate to the securities markets.

The CHAIRMAN. There are in banking. I didn't point that out to him yesterday, but I well might have. But you're an illustration of that point. You're out there, in a sense, in the non-Federal structure in one of the 50 States, and I mean there's a robust banking structure beneath the Federal level across the country.

Mr. GILLERAN. I tried to point out, in my testimony, sir, that the banking industry is different because of the fact that the bank regulation is different than other types of agency regulation in this country. We have absolute life and death control over a financial institution and there is no real argument about it when we take action.

The CHAIRMAN. But here's the difference—Federal Deposit Insurance. That's what makes banking and the thrift industry fundamentally different. And that's because we put the taxpayer on the line and we've just seen a situation where the taxpayer had to step up to the plate and write a very big check as a result of that.

Moreover, we got a situation where the Bank Insurance Fund had a negative balance within the last 2 years. Now, fortunately, that's turned around, the last report was we've got a positive balance of $13 billion.

But the previous report was that we had a negative balance, and that was a cause of great alarm. Lest you think that's an insignificant problem, we had a meeting on a Saturday, where Chairman Greenspan and the late Bill Taylor came to see me, and we talked

about the need for certain conditions in FDICIA that were of the most urgent sort with respect to the banking system.

I would not want anybody to walk away with the impression of the fact that the banking problems have gotten better, and not at the same time understand we got to a point where we had extremely serious problems in the banking system, separate and apart from the thrift industry.

And if anybody's walking around not understanding that and thinking that everything was working just fine and dandy, then you need a cold shower, because that's not what the history is.

Mr. GILLERAN. In my testimony, sir, I support the focus on the FDIC. I think it's extremely important not to leave your discussions about what to do with the bank regulatory system out of a full discussion of how to make the FDIC secure going forward. And we're concerned that it has been left out. So I agree with you that the focus on the FDIC is very important.

As to your comment about competition and conflict, I believe, myself, that the competitive aspects of this are being highly overstated. I can tell you for myself, and for any other commissioner and superintendent of banks in States that I've talked to, we simply do not proselytize to gain new charters.

So it's not a competitive aspect where we're going out and trying to get new charters. What it is is an availability of choice that is there for the banking industry to avail themselves of when they feel that it is important in order for their continued success, expansion, and profitability.

The CHAIRMAN. But let me ask you this. I've seen data that suggests that at the State level, in State regulation, there's been a consolidation. In most States now, the thrift regulator within the State and the banking regulator are being combined into a single regulator. And that the bank financial industry regulation function is not split into two operations or something more than one, but in fact, the trend is the other way. It is to bring separate operations that have been separate over the last decade together. Am I not right on that?

Mr. GILLERAN. Well, the savings and loan industry is shrinking to such a degree where it's almost becoming an immaterial point because the associations are going away.

The CHAIRMAN. But isn't that consolidation happening though? If the principle of dual regulation is there to create the tension and so forth, everything I've seen shows me that within the States, there is a consolidation going on into a single regulator. If I'm wrong on that, tell me so.

Mr. GILLERAN. I believe that consolidation is taking place because the savings and loan industry has diminished to the size where, just like your considering merging the OTS with the OCC, that's happening in the States also. It's natural when one almost goes down to zero percent volume.

On the issue of conflict, I think——

The CHAIRMAN. Well, maybe that's right. I don't want to prolong this, but let me ask you this: What percent are thrift's assets down to today in California? Less than 5 percent?

Mr. GILLERAN. I don't know. I don't regulate them and I don't have the numbers. We can get them for you.

The CHAIRMAN. Because my impression is you still have some pretty good-sized operations in California, don't you?

Mr. GILLERAN. Yes. But I believe that most of them now are Federal, federally-chartered and regulated by the OTS.

On the question of conflict, whereas, I believe that has also been used as something to avoid, if it's on the conflict of ideas, I believe that that is good for the system, and therefore, I don't think that that is a disadvantage of having two regulators.

And to answer your final question, Mr. Chairman, on the question of two regulators, I believe that that is an extremely critical point. For us to have one, single monolithic Federal regulator is completely unacceptable from our position.

The CHAIRMAN. Thank you, Mr. Gilleran.

I'm going to stop at this point, I want to get other responses, and I will, but Senator Moseley-Braun has to leave because she's got something she has to go to, as does Senator Bond.

So if I may, let me give you 5 minutes now and then I'm going to come to Senator Bond.

Senator BOND. I'll be happy to defer to my good colleague from Illinois, if you'll recognize me when I get over to the floor because I'm going the same place you are, and I'll be happy to let you.

Senator MOSELEY-BRAUN. I would recognize my colleague in any event.

Thank you very much. It's very gracious.

I would like to thank the witnesses for their testimony. I think it's been very helpful.

I'm very much concerned, as you may know, about the whole issue of taking a look at regulatory issues generally. A specific, quick question, do you agree that it is time for us to take a comprehensive look at Federal policies governing our financial system in light of the changes in the technology in telecommunications, the kind of discussion that we're talking about now, changes that are going on in terms of what the States are doing to consolidate, that it might be helpful, this kind of conversation in the decisions of this Committee, that we take a comprehensive look at what is going on in the private sector. What are the needs of the industry and what are the needs of our people with regard to a financial services sector at this time?

Mr. THOMAS. Can I respond to that, Senator?

Senator MOSELEY-BRAUN. Yes, sir.

Mr. THOMAS. I said in my testimony, and I'm on record earlier as recommending that kind of a look. Because, as I pointed out, I think the competitive positioning of the U.S. banking industry today is far and away more serious than the issue of how we are regulated.

Our ability to compete with less regulated and non-regulated sectors of the financial services industry, our global competitiveness, our viability going forward, all are very central issues of concern to the industry today. And I think are on a scale far greater than concerns about regulation.

These are steps that we should take. Ideally, we would have taken them in the reverse order, but this isn't a perfect world, and I think we should move ahead to see what we can do on the regulatory side in the current environment.

Senator MOSELEY-BRAUN. Thank you.

Mr. SHIVERS. I'd like to address that question, Senator.

I agree with my colleague, Mr. Thomas. In most cases, banks are under a terrible regulatory burden, and there are many other providers of financial services out there that are not regulated, that are eating up our market share constantly. We need to be relieved of some of the regulatory burden so we can offer more competitive products to meet the needs and the desires of our customers.

You know, the whole spectrum, there are so many providers that are non-financial institutions that have gotten in part of our business, you can cover it everywhere from insurance and other products that the consumers are looking for from a one-stop shopping thing. And I agree with Mr. Thomas that that is the bigger problem in the banking industry than the regulatory thing.

Mr. POLLARD. Senator, I'd add that I think part of what we're saying, and I've heard it from just about everyone, is it is time to begin to look at that. Now the Committee is doing both at the same time with the interstate branching bill, and the legislation that's been introduced on regulatory burden relief and action is being undertaken there.

I think it is an opportunity to look at the accomplishments of this Committee as well in FIRREA and FDICIA. While you often hear criticism of various sections that are legitimate criticism of the regulatory burden, there also is legitimate praise for those sections that dealt with the crisis that took place in the 1980's.

I hope that that would permit the Committee then to turn from the crisis to the opportunity for structuring for the future because so much has been done that's in place, and we're very concerned about safety and soundness, I can assure you. But I hope that's part of the message too. And I do believe these thing can go on at the same time; it doesn't have to be one or the other.

Senator MOSELEY-BRAUN. Exclusively.

Mr. MCMILLAN. Senator, I'd like to speak to that also.

The ABA has taken a very strong position on this question of structure being able to deliver the services that the various segment markets need now and in the future. We've established a major task force to work on this and we will have some results coming out in the very near future, and there is obviously a direct tie-in to what we can do structurally and the regulatory situations that we face. We completely agree with your assessment and are working toward some solutions.

Senator MOSELEY-BRAUN. Thank you, Mr. McMillan, because that will be very helpful to have the input for people who are there in the industry making it work, dealing with the day-to-day problems and issues. It is of critical importance to us on this Committee.

I was going to frankly ask the question about specific anecdotal instances of conflicts between this industry and its competitors with regard to the regulatory burden, how that impacts your ability to serve your customers, your ability to compete in the new playing field that we have.

But I think well, and I think—I'm trying to talk fast is the problem—I would very much like to hear some of that anecdotal advice instances, because it would be important for our Committee. We

have an opportunity to see this on a general basis, but those of you who are there on the frontline can see specifically what impacts this burden is having.

Mr. THOMAS. Perhaps just a quick point on that.

I think the studies that have been done on our industry show that in the banking industry, the overall total cost of compliance, some of which is very necessary, but the total cost runs from 7 to 12 percent of our total non-interest operating expense.

In our case, that's about $180 million. I would suggest that that percentage is far greater than in any other financial services industry by some magnitude.

Senator MOSELEY-BRAUN. I'm sorry, Mr. Shivers?

Mr. SHIVERS. Senator Braun, the IBA had a study done by the Grant Thornton accounting firm on the cost of regulatory burden. And it came up that about 30 percent of a community bank's overhead is directly related compliance and regulatory cost.

Mr. POLLARD. And, Senator, one addition as well; I think one of the issues that you should be aware of is the volume in certain areas that's a competitive problem. In the area of retail banking alone, there are more than 25 separate Federal statutes governing the provision of consumer services, and I don't think we're particularly saying a lot of those aren't valid.

You list 25 product-specific statutes, I think you can understand that community-based institutions, especially when they're having perhaps Federal and State exams on the same subject really have a burden. No one, I don't think, is debating particularly should the concern be addressed, consumer disclosure, that is, but 25 statutes is a lot just in that area that unregulated competitors may not have to deal with.

Mr. GILLERAN. Senator, one of the criteria that Senator Bond mentioned when he started would have an enormous impact on reducing the burden on banks, and that is that, and you could probably do it in very few words, is to mandate that each bank only have one Federal regulator associated with it.

That alone would cut out a tremendous burden and could be done very easily, and wouldn't require any kind of consolidation proposal to achieve it.

Senator MOSELEY-BRAUN. Well, actually, in reference to Senator Bond, he started off with a checklist earlier, and I think it would be helpful to us as you, Mr. McMillan, come up with your report, to give us a checklist or bump list or whatever you want to call it, a set of criteria that you would want to see addressed as part of our larger discussion of regulatory reform, not just consolidation but reform. And how that affects competitiveness issues, how it affects the rule system and relations between State and Federal Government and the like.

Senator Bond's approach was actually very helpful in kind of listing the bullets that he would want to focus on, and it would be very helpful, I think, to get those kind of bullets, if you will, from you.

Mr. MCMILLAN. I can assure you that that information will be made available to you.

Senator MOSELEY-BRAUN. Thank you.

Again, thank you gentlemen, very much.

The CHAIRMAN. Senator Bond.

Senator BOND. Thank you very much, Mr. Chairman.

And I'm sure that our colleagues do have some bullets on bank regulation. It seems I've heard one or two.

I would be delighted if you came up with a list that my colleague from Illinois requested. Maybe you could help us focus on what is the worst. We're not going to change all of them, but I think regulatory consolidation is one of them that we need to deal with up front.

I would just note, in following up on the discussion, I think one of the points about securities regulation, there is an SEC. But as we all know, there's a choice of regulators in the securities industry.

You can be listed on the New York Stock Exchange, the American Stock Exchange, or if you're over-the-counter, the NASD. So there is a tension among regulators on the securities issue as well.

With respect to the lessons of savings and loan, my colleague, Senator Dodd from Connecticut, and I and this Committee went to the trouble of setting up an S&L Commission, and I suggest that we all go back and read the report of that Commission so we will make sure that we will take the right lessons away.

One lesson I have from that instance is that the problems in the S&L's and some of the problems in the banks were caused by Congress itself when it changed the tax laws and destroyed the real estate industry.

So when you have $150 billion black hole, it takes a real team effort to get there. And nobody could have done it by themselves. It took a lot of folks working.

Let's get back to banking consolidation. The issue that is still up in the air as far as I'm concerned, I'd like each of you to comment on it, and that's where you move the responsibility of regulating State-chartered nonmember banks. I understand none of you has endorsed the Fed's idea of moving it to the Fed.

Would you want it to go to the Federal Banking Commission, the Fed thus could retain its authority over State-charted member banks, and then the State banks would still have a choice of regulator by determining whether or not to be a member of the Fed.

A slight variation on that would be to say that if you're part of a bank holding company whose lead bank is a State-chartered bank, then the State nonmember bank would still be regulated by the Fed. Is either one of those appealing, or is there a third alternative?

Let's just start with Mr. McMillan.

Mr. MCMILLAN. Senator, I think we're very flexible on that issue. I think there does need to be some separation, but as far as the details of how that would work, again, this is one of the problems that I mentioned earlier that's got to be worked out, and we're willing to address this with the Committee.

Senator BOND. If you have any guidance, we'd welcome it.

Mr. Thomas.

Mr. THOMAS. We would feel the same way.

The central issue is really what the Chairman suggested, and that is should there be one Federal regulator, and our Roundtable feels strongly there should be two. I think largely it's a matter of

the history, the whole culture of the banking industry. The dual banking system has been here for a couple hundred years. There's a lot of emotion and tradition associated with it.

We think the S&L example might be a reason not to have a single regulator at the Federal level. We think also having two regulators at the Federal level would do more to immunize the process from political influence.

But in terms of how we divide it up, we feel that if the Fed were to take the member banks and the Federal Banking Commission had responsibility for the nonmember banks, with the State supervisor in the various States having the primary responsibility under that Federal oversight, we would be flexible on that. And it sounds like a possible compromise.

Senator BOND. Mr. Gilleran.

Mr. GILLERAN. That would be totally unacceptable to us because our prime criteria in that regard is that the Federal charter not be the rulemaker for the State-chartered banks. So that bifurcation of the State-chartered banks simply would not be acceptable to our organization.

Senator BOND. I'll mark you down as not enthusiastic about that. [Laughter.]

All right, sir.

The CHAIRMAN. But persuadable?

Senator BOND. Doesn't seem to be but we came for guidance. We're getting it.

Mr. Shivers.

Mr. SHIVERS. Senator Bond, my bank is a State nonmember bank. But I think I can speak on this question with a lot of feeling. If I had to make a choice, I would choose to go with Federal Reserve, if there was not going to be an FDIC.

I feel like Mr. Gilleran does, that I don't think that a Federal charterer ought to be setting hard and fast rules for a State-chartered bank. And I think that the Fed ought to, I like the idea of cutting out the duplication.

If you take a holding company and the lead bank in that's a State bank, let the Fed have it. If it's a national bank, let the Federal Banking Commission have it, and take the whole structure. But I think we need a choice and we need to preserve the dual banking system and the role of the Fed and FDIC.

Senator BOND. Mr. Pollard, do you want to kick around my idea before we bury it, or are you just going to let it die?

Mr. POLLARD. Does that mean my comment will either bury it or keep it alive?

Senator BOND. It's not healthy right now.

Mr. POLLARD. I'll just speak quickly and say that a single regulator for holding companies would have an appeal to SCBA.

Then on the State nonmember bank issue, we would basically have to say that the transfer to us, is secondary to the expertise that governs it.

Senator BOND. Excuse me?

Mr. POLLARD. The expertise, the professionalism on the staff and the structure around it is very critical to us first. That's why some of what was discussed in this Committee yesterday was very inter-

esting for us. How it's going to be structured, where it goes, whether it be the Fed or the Federal Banking Commission.

Senator BOND. One of the questions that several of you all mentioned and something that's been brought up is whether the FDIC should have a seat on the board of the Federal Banking Commission or where its regulatory powers should go.

I'd like to go down the line again and just get your views on what happens, where the FDIC should go.

Mr. McMillan.

Mr. MCMILLAN. We've not taken a definitive position on that. I think this is something that we need to think about and work on. I think the key or the underlying principle here is that there needs to be independence from political pressures, no matter what structure we come up with for membership on the Commission.

Senator BOND. It should be on the Commission? The FDIC should?

Mr. MCMILLAN. We are flexible.

Senator BOND. Yes. FDIC on the Commission.

Mr. Thomas.

Mr. THOMAS. We don't have an official position on that except that we think the FDIC probably can get out of the business of regulating healthy banks. We think there are too many regulatory agencies out there. And consolidation, this is the one that we think ought to focus on the insurance business. I think it would probably be appropriate for it to be represented on the Commission.

Senator BOND. Mr. Gilleran.

Mr. GILLERAN. We have no position on that.

Mr. SHIVERS. We have no position on it except that we don't want to see the process politicized.

Senator BOND. All right.

We may have some further questions for the record, but I just want to clear up one thing. A couple of days ago, I asked Secretary Bentsen why he thought the industry did not support the Administration's proposal and he said that probably because there's been some misunderstanding about the proposal. And I just wondered if any of you are unenthusiastic because you don't understand it. Is there anybody whose lack of enthusiasm is based on lack of understanding?

Mr. MCMILLAN. I think we understand the proposal.

Senator BOND. Mr. Thomas.

Mr. THOMAS. I think there might be some misunderstanding the other way around. I don't think there's misunderstanding.

I would just make the point that on this issue of dual versus single regulator, I think our industry is subjected to the most intensive regulation of any industry that I know of. It's intensive and it's, indeed, even personal when you have examiners living in your house all the time. It's intrusive and it should be to some extent, but it's a big change from the way we used to do business, and I think the prospect of housing all that power in one Federal regulatory agency is absolutely frightening to most banking institutions in this country.

Senator BOND. And at least to this Member of the Committee.

Mr. Gilleran.

Mr. GILLERAN. I think the reverse of that is true. I've met with Treasury at least three times, and we talked about the fact of the unacceptability of the single regulator concept. But, yet, they simply don't get it.

Senator BOND. Mr. Shivers.

Mr. SHIVERS. Senator Bond, Secretary Bentsen and I and our families go back a long way, and we're very, very close friends. On this thing, we agree to disagree.

But I agree with my colleagues' comments. That just the thought of putting this much power in one agency's hand is terribly frightening.

You look in history, any country that politicized their banking and monetary system now either does not exist or is a third rate power. When you politicize that system and put all that control in one agency's hands, it's dangerous, dangerous, dangerous.

Senator BOND. Mr. Pollard.

Mr. POLLARD. To the question of enthusiasm for the Administration's proposal, I guess what I'd comment is that the proposal begins the process that we have wanted to see, which is putting some flesh on the bones and we're enthusiastic about that. There are a lot of points we would agree on or disagree on, but I think we were pleased to see, finally, some sort of statement of a few specifics. I won't go through them with you here, but I think that, as the Committee pointed out yesterday, on independence, at least now we can respond and say, well, are the terms being coterminous, independence or not, like that. And we're very positive about finally getting it out.

Senator BOND. Mr. Chairman, and members of the panel, my sincere thanks.

I think that that's certainly been helpful to me, and I think this is helping us move down the line. We welcome your continued input and views as we try to reform it. We may come up with some ideas that you don't like and we'd like to hear, Mr. Gilleran, from you and others when we do that.

Mr. GILLERAN. I can guarantee it, sir.

[Laughter.]

The CHAIRMAN. Before you leave, Senator Bond, let me say—I've said this before, but I think it is of great value. I appreciate the line of questioning you've just developed and the great value that you bring to this Committee on all issues as well as this one. But I'm struck by the fact that sometimes when people have been governors of States and they've had to live with these issues at a different vantage point, that that's a wonderful experience to be able to bring to this Committee. And I find that reflected, quite often, in the quality of your questions and the receptiveness to the questions that you raise and it's a great help to the Committee.

Senator BOND. Thank you, Mr. Chairman. I appreciate your kind words.

The CHAIRMAN. Let me ask you a couple of other questions that relate to these broader issues that we're touching on.

I'm concerned about what constitutes today's banking business charter. And we thought a lot about that and tried to have that issue central to our thinking as we were going through some of the difficult legislative efforts of the last few years.

Because I'm very conscious of the number of shrinking assets within the banking system and we actually passed out of this Committee, as you know, a banking reform bill that I think was a pretty good bill. And we could have taken it all the way through. I won't take the time today to talk about why it hit the rocks, but it passed the Senate. It had in it not only interstate banking and branching, which we're bringing back through now, but also we had resolved the Glass-Steagall issue, we had resolved the insurance issue, and we thought we had a pretty good package that, had we been able to get it all the way into the end zone, would have had valuable modernization aspects to it.

There was a wonderful meeting one evening with John Dingell and Nick McBrady, I asked them to meet with me for dinner to see if we couldn't resolve the dispute on Glass-Steagall and it was the collision of two worlds, and there were a couple of compromises there that I think the Administration should have taken, and they chose not to, and so that sent those issues down the track for another day.

But here are two large questions for you to just react to.

One is the question as to whether, over time, the commercial banking system should continue to have a Federal deposit insurance aspect to it, and all of the related things that come with that. And that's really what differentiates banking from any other part of our business structure.

I once asked Walter Riston, in this room, when he was running Citicorp, how he would feel about just giving up Federal deposit insurance, and running a banking institution without it, and at the same time presumably shedding a certain amount of Federal regulatory burden and oversight that goes with it.

He thought about it for awhile, and he decided that he'd just as soon keep the Federal deposit insurance and struggle on with the other things he didn't much like that often went with it.

I pose the question not just as a rhetorical question, but because I think the connection to deposit insurance and the history that we've had tends to create a great concern about safety and soundness to gear into the worst case which we occasionally see, seen within the lifetimes of some of you here, more than once, the banking system back in the 1930's.

So if we found some way to handle banking without Federal deposit insurance and that's another avenue that one might think about.

Now, I think, it's inconceivable today to think about that in practical terms, but I think as long as Federal deposit insurance is there, there's a certain safety and soundness regime that comes with it that's never going to be perfect, never going to be as streamlined as we'd like it to be or perhaps you'd like it to be.

The other thing is that I'm concerned about what constitutes a banking business charter in today's world. If you're going to continue to have the link to the Federal deposit insurance, what should be the scope of business and how far out can we take it so that we avoid problems that we don't want that could put the industry at risk and maybe capsize the insurance fund.

But what should constitute a range of business activity that really allows banks to do a better job of competing with all of the other

financial players that have come into the game in the last 10 or 15 years?

It is a very difficult issue to try to think through, and the nexus back to deposit insurance is a critical element in any kind of discussion like that. But I would welcome any thoughts any of you have on those points.

Mr. Gilleran.

Mr. GILLERAN. I've sort of thrown myself on the spike with concerns about the structure of the banking industry. I believe that is more important than minor changes in the regulatory structure. And my concern with it is that there's only basically four types of broad intermediary activities. There's being a principal, there's being an agent, there's being an advisor, and there's being a processor of data.

The principal business for the banking industry has been shrinking because the nonbank banks and some of the other less regulated organizations are able to extend credit which is beneficial for the American consumer and should not be stopped, but it's obvious that the banking industry's control of that principal activity is diminishing and probably will never return to its former status.

Therefore, it must be allowed to fully participate in all other areas of intermediary activity in the agency and advisory and processing area in order to remain as a competitive and effective part of our society.

I agreed with you. You said earlier that you thought the banking industry was our most important industry. It is, in my opinion, as well as yours. And I think that it is the industry that allows America's funds to trickle on down to the small communities of America that support small business, that support most of the job creation in this country, and also support the greatest thing that we have, which is creativity development. Creative development is our biggest asset against all other nations. We're the most creative Nation.

I believe that the structure of our banking industry has allowed that to happen. And that also relates to deposit insurance. Because I believe that what separates the American system from other systems, that in Canada, that in the U.K., and elsewhere, is the fact that where you don't have deposit insurance, you have an aggregation of the banks and you'll probably end up some place in America with ten major banks across the United States through branching structures.

And that——

The CHAIRMAN. Some people think we may be headed to that anyway.

Mr. GILLERAN. Right. But I would say that without deposit insurance, I don't think that you would have community banking. I personally believe that community banking is extremely important and is a very major contributor to the success of America.

So my answer is that I believe that deposit insurance must be continued.

Mr. POLLARD. Senator, I'd add, following up on the deposit insurance point, that certainly savings institutions feel, particularly as community-based institutions, that this is a vital issue.

I think the point you're making, though, about looking to the future on business charters and items is useful.

In our testimony, we suggested both enhancing the dual banking system and addressing this very point, which would be the concept of taking what was built in FDICIA on the FDIC authority over State bank activity and adding an element that says, if an activity—two categories currently—is permitted to national banks or the FDIC determines it is not a threat to the insurance fund. Adding to that a third alternative which would permit innovation at the State level, an incubation period, and that would be to permit those activities that fall in this third category to be permitted if funded with non-depository funds.

This would let capital be put into those activities separately. They could be gestated for a few years, and if it turns out they're responsible, safe activities, then they can be put into the other two baskets.

The CHAIRMAN. Yes?

Mr. MCMILLAN. Mr. Chairman, I think your question is extremely important and very timely. And it's difficult to answer.

I think FDIC insurance is certainly important to the community bank system which is really the backbone of our banking system and the part of the banking system that really gets in and serves the day-to-day needs of the various communities that they're in.

Having said that, we are in a very competitive business. The financial services industry has changed significantly and I think it's important for the continued health of the country to have a viable banking industry that is able to compete. And I think the challenge there is how do we allow our banks to compete, move into some of the areas that all of us know we need to be in, but at the same time, insulate the FDIC fund.

That's part of the work going on at the ABA right now with our look at the whole issue of structure, market share, and so on and so forth. We will be bringing the results of that back to you.

The CHAIRMAN. Mr. Thomas, before you go ahead, and I want to hear from you next, I can imagine that that change in competitive environment has probably put some of those white hairs on your head and maybe taken some of those hairs off of Mr. Thomas' head.

[Laughter.]

Mr. MCMILLAN. Mr. Chairman, I'm only 35 years old.

[Laughter.]

The CHAIRMAN. Mr. Thomas is only 25 years old.

[Laughter.]

Mr. THOMAS. If I could address the second question first: What is our business charter? I think that is really central to any discussion about our industry. And it is a matter of considerable discussion today. When I look at the banking industry, I think it is at the nerve center, in many respects, of the economy.

Three principal banking functions to me are lending to small business, which equates to job creation, and there's no one else out there that does it quite as extensively as we do.

It is the operator of the payment system in this country which is not visible to a lot of people, but when you think about it, it's a very important function.

And we are the organizations through which monetary policy is implemented.

So it concerns me greatly on the part of the country when our share of the total financial marketplace continues to diminish because I think the effectiveness of these various functions is compromised.

The CHAIRMAN. I must tell you, before you go ahead, I'm concerned about that too.

Mr. THOMAS. I know you are and I appreciate that.

It's kind of ironic that whenever we have a new situation in Eastern Europe or in China, we immediately dispatch experts over to help them design a strong banking system, but here at home, we don't seem to have as much focus as we sometimes do abroad.

We also have important roles in providing transaction services to individuals, that is, checking accounts and as a savings depository. And in those two roles, I think our competitive position is going from bad to worse.

We just cannot compete economically with the mutual funds, with the money market funds, with investment banking firms, for a variety of reasons. And we've got to find a way to compete more equitably in offering investment products and other products to the consumer in this country.

Finally, I think we need to have greater competitive equality in offering a variety of corporate financial products and insurance products which most other organizations can do, unless they happen to be a commercial bank.

So I think that that is the number one problem for our industry, how we can become more competitive in this rapidly changing world, while preserving safety and soundness.

On the FDIC——

The CHAIRMAN. Could I just react to that before you go ahead.

Now I realize you're on the other side of this issue, and who knows who's right or wrong. I'm just trying to make a careful judgment and balance the interests here.

I think one might argue that the logic of a well-designed, well-functioning Federal Banking Commission, is it needs more members, and maybe it needs staggered terms and things of that kind, but if you had a centralized highly competent able Commission of that kind, that one of the issues that they would take up first, I would think, would be the very issue that you've cited. And that's what the future of banking is in this country and what is happening to the business charter of banking.

It may very well be that part of this fragmentation has, in effect, ended up creating a diffusion of focus and an over-reliance on bookkeeping as opposed to any kind of strategic vision as to where this industry really fits in and where it fits in heading into the next century.

And it may well be, in my mind, what I envision for a Federal Banking Commission, if we don't get this kind, then we've missed the boat again, is a Commission that can really help think about that question, and maybe help get these kinds of issues up on a national radar screen and into the debate so that it either isn't a tiny paragraph on page four of the business section, if it gets into the newspapers at all.

So I think there is some potential value into a properly devised system and it's got enough elegance and enough strength, a Federal Banking Commission that may, in fact, help deal with that problem in a way that you're not getting now.

Mr. THOMAS. I know the Administration has pointed that out and I think that would be a very positive result if that could be achieved—whether it's a single commission or a commission with the Federal Reserve. But, certainly, we need to focus on that and through a new Banking Commission, I would hope that that could be done.

The CHAIRMAN. It seems to me that the logic there would be that, let's say you're on a Federal Banking Commission, I would think that one of the very first things you'd worry about is whether the part of the economy over which you have this important responsibility is dwindling and shrinking and being sort of chipped away from every direction.

I would think that that kind of a group, properly constructed, may be the only way you're going to get to that kind of issue. I mean there are a lot of other issues to fight through. There's Bosnia, and there's health care reform, and so forth and so on. If you don't have some real professionals that are willing to devote themselves to thinking about these questions, who does the down field blocking?

Mr. THOMAS. We have proposed a financial services holding company, that is, our association has, that would enable us to participate competitively in other aspects of the financial services industry while still insulating the banks appropriately for safety and soundness reasons.

But I get the point. Who's going to take up the cudgel on our behalf? Senator Braun has recommended a commission. We've had a lot of commissions before. Maybe we need one again.

The CHAIRMAN. Well, I don't think it should be just a study commission.

Mr. THOMAS. No, no.

The CHAIRMAN. I think it's a question of you've got to have a kind of line operation that can get at this. I mean I think now we're suffering from a fractured, diffuse system, too focused on the past and poorly focused on the future.

Mr. THOMAS. I agree completely.

The CHAIRMAN. Obviously, we've got to draw the lessons out of the past, and I've tried to do a little bit of that today. But if we don't have a future orientation here as to where we're going, I think we're really missing the boat.

Mr. THOMAS. I agree with you.

On the question of deposit insurance, I think it is an issue of infinitely greater importance to the smaller banks. I think it's critical for the foreseeable future to their success and livelihood, and it's less a factor—this is more of a personal observation at this point—to the very largest banks. Over some period of time, there may be a way for us to not have to depend on Federal deposit insurance to do our business.

The CHAIRMAN. Interesting.

I want to make sure everybody has—I want to finish on this point today, but I want to be sure everybody else that has a comment has a chance to make it.

Mr. Shivers.

Mr. SHIVERS. The constituents Mr. Thomas represents are the banks that are too big to fail. The rest of us want to keep our FDIC insurance, Mr. Chairman.

The community banks, what we really want for competitive environment, Mr. Chairman, is agency powers or agency status to offer services as a provider, like a general insurance agency or something. The bank provides the services, insurance services to their customers.

And not to get into underwriting and managing mutual funds and so forth. But there are many other industries out there that have carved out a piece of our business and have taken some of our market share over the years.

The easiest way to do something like that would be to put them under the same regulations that we're under, and they'd run from that business.

This is why they are more competitive than we are. They don't have the tremendous burden of the cost of these regulations that the banking industry is suffering under. And so they can be much more competitive from a rate-wise environment and they don't have to meet all the laws and all the regulations and the other problems we have, especially with the EPA regulations. It's not part of this hearing, but it is of vital concern to the banking industry. But we want to keep our insurance.

The CHAIRMAN. Did you want to add something?

Mr. POLLARD. Senator, I actually already had a chance. I'll just comment on one last item.

Your turn to this is something I think is important. The Administration proposal, section 301, says "and regulation shall be crafted." That's what we're talking about, the opportunity to put some of what you've just said into a proposal to make Federal Banking Commission multiple, or however it ends up, the opportunity to put just what you've been talking about—look into the future, structure, shape, competitiveness—in that language. I think it is something that would make what is now just a rough section 301 into something a little more attractive and interesting to everyone.

The CHAIRMAN. All right. We'll take a look at that.

Mr. GILLERAN. Senator, I think that two Federal banking regulators would produce more creativity. And I think the one Federal bank regulator would end up being a risk-adverse organization and would not provide the creativity that we all seek.

The CHAIRMAN. Well, you may be right, but I want to tell you this. We've got four now, and I would say, why isn't the proof of the pudding in the eating? I mean, you've got four now and one of the remaining two, if we're going to go down to two, is there now and if out of that diversity and multiplicity comes some great virtue, why aren't we seeing the virtue? Why isn't the virtue manifest in terms of a better picture than we now see?

Mr. GILLERAN. I think the reason is because if you go to one Federal bank regulator, you will destroy the dual banking system,

which will eliminate whatever creativity has come out of the system.

The CHAIRMAN. Well, we have no intention of doing that. We're not going to design something that's going to destroy the dual banking system. That's not something we want to do or will do.

Let me just say, I'm not convinced of the argument that a single banking commission destroys the dual banking system. I mean, you put that premise out there, and that's a judgment, and I don't think one follows from the other. But the point is, our intention here is to design something that is going to preserve the dual banking system.

Gentlemen, thank you very much. You've been very helpful.

The Committee stands in recess.

Let me just reconvene for a moment. I received a letter from Roger Altman, dated March 2, 1994, on the matters that we talked about at the beginning of the hearing, and I want to insert it in the record at this point.

The CHAIRMAN. The Committee stands in recess.

[Whereupon, at 12:25 p.m., Thursday, March 3, 1994, the Committee was adjourned, subject to call of the Chair.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR BOXER

As I have indicated throughout the Committee's discussion of this issue, I support reform of the current Federal banking regulatory system. I support reform because I want to lessen the burden on our institutions. I also support reform because a clearer regulatory system will facilitate the enforcement of laws that are in place to protect consumers and promote fair and equal lending in our communities.

I commend the Chairman for holding this hearing to give the industry, the regulated, the opportunity to offer their views as to the best way to reform the system. I look forward to hearing from our witnesses today so that we may consider their important perspective as we develop our eventual proposal which I am confident will benefit the industry, the consumer, and the country.

Thank you.

PREPARED STATEMENT OF HOWARD L. McMILLAN, JR.

ON BEHALF OF

THE AMERICAN BANKERS ASSOCIATION

Mr. Chairman, I am Howard McMillan, President and COO of Deposit Guaranty National Bank in Jackson, Mississippi, and President Elect of the American Bankers Association. The American Bankers Association is the only national trade and professional association serving the entire banking community, from small community banks to large bank holding companies. ABA members represent approximately 90 percent of the commercial banking industry's total assets, and about 94 percent of ABA members are community banks with assets less than $500 million.

I am pleased to be here today to present the views of ABA's members on the issue of reconfiguring the Federal banking regulatory structure. This is an issue of utmost importance to bankers, and one that deserves very careful and deliberate consideration. I would like to congratulate you, Mr. Chairman, and Senator D'Amato for your leadership role in highlighting some of the problems of the current system of bank regulation and examination, and in providing a forum for a thorough discussion of the issues. We look forward to working with this Committee, the Regulators, and the Administration to find a workable structure to improve and streamline the bank examination and supervision process. There are a number of thorny issues that need to be worked out, but we are ready to roll up our sleeves and get to work on them.

If we were to start from scratch to design a bank regulatory system, it would probably not look much like the one we have now. I think we would all agree it doesn't make much sense to have all four Federal regulators examining the same banking organization for compliance with the same laws, as is often the case today. This regulatory overlap results in a very costly burden on banking organizations in terms of time spent sorting out and complying with the regulatory interpretations of different agencies. Between multiple safety and soundness and compliance exams, many banking organizations have a cadre of bank examiners in their institutions virtually year round. And in addition to multiple exams, any actions that require regulatory approval (such as branching or acquisitions) are also complicated by the need to deal with multiple Federal agencies.

As I travel around the country in my role at the ABA, I hear many incredible stories about multiple exams from bankers. I hear from small banks that have teams of examiners, almost as large as their own small staffs, in their banks for weeks only to see another team from another regulator come a few weeks later. At one bank, customers couldn't park in the lot because of all the examiner's cars.

The current regulatory overlap is also costly in terms of paying for unnecessary duplication in the regulatory apparatus itself. Maintaining four separate examination forces at the Federal level is clearly an expensive exercise in redundancy. And the great difficulty and expense of having four Federal regulators (with their teams of lawyers) negotiate virtually every regulation, guideline, etc., should not be underestimated. And because the banking industry foots the bill for its examinations and supervision, bankers have a strong interest in assuring that the system of regulation and examination be as efficient as possible.

However, while we recognize that the current regulatory structure has many shortcomings, it also has many desirable features that work well and should be preserved. First and foremost among these desirable features is the dual banking system. This country has the most diverse and competitive banking system in the world—and the dual banking system is a key reason why we have been able to develop and maintain such a system.

Since 1782, States have chartered and regulated banks. The ability of States to design a State banking system suited to the needs of their citizens has facilitated the development of a diverse and flexible banking system. Following the National Bank Act in 1863, the Federal Government also began chartering and regulating national banks. The checks and balances inherent in such a dual system has fostered the creation of an innovative network of large and small banks capable of responding quickly to local, national, and international market needs; this diversity would not have occurred without real choice of a charter. The 200 year heritage of States' involvement in banking is worth protecting.

After a great deal of consideration, we have come to the conclusion that the concept of a single Federal regulatory system, no matter how it is structured, is incompatible with maintaining the dual banking system. Collapsing all Federal regulatory power into one monolithic agency would eventually make the dual banking system an empty shell—a State charter versus a national charter would be a distinction without a difference. Bank customers and our economy will be ill-served if we sacrifice the benefits of the dual banking system in the process of consolidation.

Mr. Chairman, in a perfect world, proposals for reconfiguring the Federal bank regulatory agencies would be considered in the context of overall financial modernization. It is becoming more evident every day that market forces have simply overrun the legal barriers that have traditionally separated financial service providers. Financial innovations such as securitization allow nonbank firms to offer products virtually identical to bank products. In light of these revolutionary changes in financial markets, the legal and regulatory structure which now constrains the roles of all financial service providers must be reassessed. It would certainly make a great deal of sense to look at industry modernization and reorganization of the regulatory agencies together.

But the real world is not a perfect place, and we don't always have the luxury of choosing when we can address a particular issue. The fact is that proposals for agency restructuring are on the table *now*—and that means that we have the opportunity to make improvements to the existing regulatory system *now*. However, we must all work together to assure that proposals to change the bank regulatory structure are sufficiently flexible to accommodate industry modernization. Failure to do so will surely mean that we will have to revisit this issue again in the near future.

Principles for Judging Reform Proposals

The ABA's Board of Directors and Government Relations Council met recently to consider agency consolidation proposals. These two bodies, which include over 100 bankers, represent large and small banks serving urban and rural markets across the country. Based on their deliberations, ABA developed six criteria against which any consolidation proposal should be judged. I would like to share these six criteria with the Committee this morning.

1. THE PROPOSAL MUST PROTECT THE DUAL BANKING SYSTEM

The dual banking system embodies the balance between State and national interests. It has served our Nation's economy well by providing flexibility and allowing innovation that are the bulwarks of a healthy banking system.

Many things that are commonplace in our banking system today are a direct result of innovations at the State level. For example, NOW accounts, which enable consumers to earn interest on transactions balances, were pioneered by a State-chartered Massachusetts bank. The variable rate mortgage, which has clearly been a tremendous benefit to consumers by increasing the options available for financing the purchase of a home, is another example of State innovation. Even interstate banking, on which this Committee just last week took such significant action, owes its beginnings to State bank regulators—it was the State of Maine that took the first step by allowing out-of-State bank holding companies to acquire banks in Maine. That concept has now spread to the point where 49 States allow interstate banking—some on a regional basis, most on a nationwide basis. Furthermore, improvements in examination techniques, examiner training, and bank regulations have resulted from the dual banking system.

We do not believe the creativity of the dual banking system can survive with a single Federal regulator. Maintaining healthy competition among Federal regulators by giving banks a meaningful alternative in their choice of charter will help to guard against overly rigid and inflexible Federal regulation. With a single regulator, where is the incentive for efficiency and cost control? Where is the incentive to provide flexible and reasonable regulation? To be blunt, where is the incentive to resist bureaucratic featherbedding and maintain high-quality examiners?

I know that some will characterize the current structure as "competition in laxity." Mr. Chairman, bankers rely on public confidence, and they know well that it

is not in the best interest of the public or the industry to have lax regulation or to permit banks to engage in unsafe or unsound practices. After all, we bankers have paid every penny of the cost of bank failures and are currently paying very high premiums to rebuild our insurance fund.

We understand that establishing the proper regulatory balance is both important and difficult. But we believe that this balance is more likely to result from a system that allows for flexibility and choice than from one that vests all power in a single agency. Our free market economy is based on the principle of competition. It is rare that the market discipline which keeps the private economy healthy is found in a Government bureaucracy. Let us not destroy this worthy attribute by creating a monolithic and monopolistic regulator.

It is also worth remembering that the S&L industry, which suffered probably the worst regulatory failure in history, had a single Federal regulator.

2. The Proposal Must Result in Significant Cost Savings and Less Regulatory Duplication

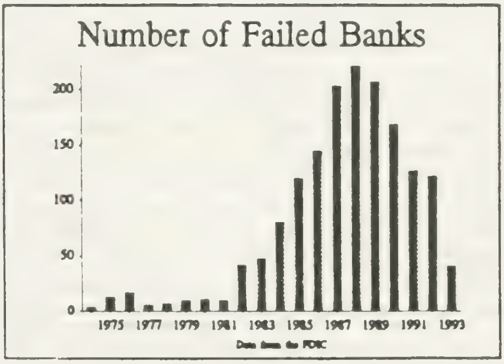
One of the most important goals of proposals for agency consolidation is to streamline the system by reducing unnecessary duplication of regulation and examination. For many banking organizations, such streamlining should reduce both the cost and the loss of management time involved in examinations. As the system works today, bank holding companies that have both State and federally-chartered institutions may be examined by as many as four Federal regulators. One simple solution to this problem is to place supervision and examination authority for the holding company and its insured subsidiaries with one Federal agency. Clearly, accomplishing this change does not require that there be a single Federal regulator—just that there be one Federal regulator per banking organization.

Before any consolidation plan is approved, bankers would like to see reasonable evidence that it will result in significant and demonstrable savings. This is nothing more than any enterprise would require before entering into a merger agreement in the private sector. As we go about "re-inventing" Government, it is particularly important to apply this basic business principle because the incentives in merging Government agencies are often directed at merging budgets and staff rather than reducing costs.

It goes without saying that cost savings should not come at the expense of industry safety and soundness. However, we are confident that effective streamlining can be designed that will increase safety and soundness, not decrease it.

3. Consolidation Must Not Lead to a Merger of the Deposit Insurance Funds

The banking industry is opposed to a merger of the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). Bank premiums—not the taxpayer—have covered every single cent of the cost of every commercial bank failure since the FDIC was created in 1933.



Our industry has just worked through several difficult years. As the above chart shows, the banking industry has covered the cost of over 1,400 bank failures during the past 10 years. The BIF balance is rising rapidly as a result of bank premium

payments, which are currently set at many times the premium normal rate, and recapture of excess reserves. The fund balance now exceeds $13 billion even after reserves for future losses are subtracted. We expect the BIF to reach the statutorily mandated level of 1.25 percent of insured deposits by 1996.

The S&L disaster has already had a very negative impact on banks due to the market distortions caused by the continued operations of insolvent thrifts and competition from hundreds of Government-run S&L's which should have been shut down. It would be patently unfair to saddle the banking industry with paying premiums for the problems of the thrift industry, and we will oppose any consolidation proposal that would do so.

4. The Proposal Should Include Credit Unions

Many credit unions are no longer Mom and Pop organizations. They have become full-service financial service providers; in fact, in many markets, credit unions are larger and offer more services than the banks with which they compete. If one of the goals of agency consolidation is to ensure a more uniform system of regulation and supervision among depository institutions, credit unions should be included in the proposal. Shouldn't credit unions be held to the same high standards of bank supervision? Is there any less commitment on the part of the Government to assure safe and sound practices for credit unions than for banks and thrifts?

5. Bank Regulation and Supervision Should be as Independent as Possible

The banking industry is the central component of our financial system—in fact, banks are the single most important supplier of credit to the U.S. economy. Bank loans to businesses, consumers and State and local governments support job creation and economic growth. In addition, banks are often the backup source of credit to other lenders. Because of the pivotal role banks play, it is critical that they be insulated from political pressures. If banks are to fulfill their role as providers of credit and other vital financial services, they must be free to respond to market conditions—they must not be subjected to the pressures of political credit allocation. We also believe that an independent regulatory system is the best way to ensure safety and soundness is not compromised.

6. The Federal Reserve Plays an Important Role in the Economy

The Federal Reserve is largely responsible for maintaining economic stability in this country. As part of this role, the Fed sets and implements monetary policy, oversees the integrity of the payments system, and acts as a crisis counselor and coordinator to the financial system during times of economic turmoil.

In each of these roles, the Fed works closely with the banking system. In the conduct of monetary policy, banks are a critical link between the Fed and the economy at large. This close relationship between the banking system and the Fed has served our economy well. We need to be careful not to disrupt this inter-dependency by isolating the Fed from the banking industry.

Mr. Chairman, the complexity of the current system means that restructuring agency responsibilities will not be a simple task. The potential for unintended consequences is great—and because banks play such a critical role in financing economic growth, the repercussions of these unintended consequences would be felt throughout the economy.

Our point is certainly not that there should be no change, but that we must move carefully—we must set achievable goals that will increase efficiency without sacrificing those elements of the existing structure, particularly the dual banking system, that help make our banking system both flexible and responsive to the demands of a diverse and growing economy. We also believe it is important to develop as broad a consensus as possible so that the transition to the new structure is smooth and not undermined by in-fighting and second guessing.

I would like to add one brief comment on the relationship between agency consolidation and the regulatory burden. While duplicative regulation certainly contributes to the banking industry's regulatory burden, unsnarling the current regulatory tangle does not fully address the larger problem of overregulation and micromanagement of banking organizations. Over the past few years, the industry has been virtually buried in an avalanche of new regulations—there is little doubt that the biggest part of the regulatory burden on banks stems not from too many regulators, but from too many regulations. This problem can not be solved by regulatory consolidation alone. The legislation this Committee reported late last year to reduce unnecessary red tape is a good start, but we hope more can be done as we go forward.

We look forward to working with this Committee, the regulators and the Administration to identify ways in which we can make improvements to the existing regu-

latory system. We appreciate your leadership on this issue, and will be glad to answer any questions you may have.

PREPARED STATEMENT OF RICHARD L. THOMAS

ON BEHALF OF

THE BANKERS ROUNDTABLE

Mr. Chairman and Members of the Committee, I am Richard L. Thomas, Chairman and Chief Executive Officer of First Chicago Corporation, headquartered in Chicago, Illinois and President of The Bankers Roundtable. I am appearing today on behalf of The Bankers Roundtable, which was formed in mid-1993 by the merger of the Association of Reserve City Bankers and the Association of Bank Holding Companies. The Roundtable membership is composed of the Nation's major banking companies. The highest-ranking executives of those companies serve as representatives to the Roundtable. Our member companies hold approximately 70 percent of the Nation's commercial bank deposits, operate in virtually every State and employ almost one million individuals.

First Chicago Corporation is subject as a holding company to the regulation and supervision of the Federal Reserve Board through the Federal Reserve Bank of Chicago. Two of its three largest subsidiaries are national banks, regulated and supervised by the Office of the Comptroller of the Currency (OCC). The third subsidiary is a bank holding company, supervised by the Federal Reserve Board with banking subsidiaries supervised by the OCC. All these banks are also subject to supervision by the Federal Deposit Insurance Corporation (FDIC) which insures the deposits they maintain. In addition, we are involved in several other businesses, which because of banking law, must be conducted through nonbanking subsidiaries of the Corporation. These include:

- A trust company chartered in New York, regulated and supervised by both the Federal Reserve and New York State banking authorities.
- A mortgage servicing subsidiary historically regulated and supervised by the Federal Reserve, but recently also examined by the OCC.
- Capital markets subsidiaries, regulated and supervised by the Federal Reserve, the OCC, National Association of Securities Dealers (NASD) and the Commodities Futures Trading Commission (CFTC).
- Venture capital subsidiaries, now regulated and supervised by both the Federal Reserve and the OCC, as well as the State of Illinois and one of them by the Small Business Administration (SBA).

In addition, while First National Bank of Chicago is regulated and supervised by the OCC, its international (Edge Act) banking subsidiaries are regulated and supervised by the Federal Reserve.

As the Chief Executive Officer of a large and diversified banking company, I obviously have a keen interest in the issue of bank regulatory reform. As important as this issue may be, however, the issue of fundamental and comprehensive reform of the banking system is even more important. That issue should logically be addressed first before any reform of the bank regulatory structure is undertaken.

Having said that, it is clear that the current bank regulatory structure is unnecessarily complicated, redundant, and duplicative. The membership of The Bankers Roundtable believes that there are changes that can and should be made to streamline the Federal banking regulatory and supervisory system and make it more responsive to the regulatory and competitive challenges facing banking today. This can be done while still maintaining the safety and soundness of the banking system.

These changes would represent a positive contribution the Committee could make to improving the operating efficiencies of the Nation's banking system. The Committee has clearly made a very important contribution in this direction by approving an interstate banking bill. The Bankers Roundtable congratulates the Committee for its actions, and appreciates in particular the leadership of the Chairman, the Ranking Republican Member, and Senator Dodd in securing the Committee's approval of this important legislation. This is a crucial step in allowing the Nation's banking system to better serve the public.

In similar fashion, appropriate changes in the bank regulatory system would also allow the banking system to better serve the public. The letter of invitation from the Chairman and Ranking Republican Member asked for the Roundtable's assessment of the advantages in reorganizing the banking regulatory system and how a new Federal banking agency should be properly structured. We commend the Committee for its interests in this important subject. This issue has been given top pri-

ority by the Roundtable membership and staff over the past several months. My statement today represents the Roundtable's consensus on the issue at this time.

The Need for Regulatory Reform

The Bankers Roundtable believes that, as with interstate banking, the time has come to reform our Federal banking regulatory and supervisory structure. Consequently, The Bankers Roundtable seeks to work with the Committee, the Administration, and the banking regulators to develop a workable reform plan.

As the Committee Members know, the Treasury Department and the Federal Reserve Board have put forward alternative proposals for revising the current bank regulatory system. Each alternative has its supporters in Congress. The Committee Chairman and Ranking Republican Member have put forward their own proposal (S. 1633).

The Bankers Roundtable has met with officials of both the Treasury Department and the Federal Reserve Board to discuss their proposals in considerable detail. The Roundtable informed both the Treasury Department and the Federal Reserve Board that there are significant issues of concern to the Roundtable membership in both proposals. The Administration plan is viewed as too disruptive to the current system of State-chartered and federally-chartered banks. The Federal Reserve Board's proposal is viewed as possibly going beyond its stated need to supervise banks for regulatory, monetary policy, and payments system purposes.

The Roundtable, however, believes that the proposals of the Treasury Department and the Federal Reserve Board can provide the basis for a solution that would respect our State and national banking systems while, at the same time, achieving a meaningful and realistic streamlining of the Federal banking agencies. The Bankers Roundtable joined the American Bankers Association in calling on both the Treasury Department and the Federal Reserve Board to develop a common approach.

Reform of the regulatory structure is important for two major reasons.

First, regulatory reform can and should give the Federal banking agencies the flexibility to adapt to the changes underway in the marketplace and to facilitate a much-needed modernization of banking in the near future. The business of banking has changed dramatically in recent years. Banking companies are now engaged in a wide range of banking and nonbanking activities unheard of when the current regulatory structure was devised. Furthermore, the lines between traditional banking products and other financial instruments are increasingly blurred.

The future of the Nation's banking system is ultimately dependent on the modernization of the Nation's banking laws. Those laws control both the banking regulatory structure and, more importantly, the competitive structure for banks. Ideally, we would like the Committee to address both of these issues. Even more ideally, a modernization of laws and regulations allowing banking to be more competitive and efficient would precede a restructuring of the bank regulatory system.

Second, reform of the bank regulatory system is important because there has been a virtual explosion in compliance requirements for banking dictated by laws such as the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Congress imposed these requirements, in part, because it had grown skeptical of the ability of the Federal regulators to maintain the safety and soundness of the Nation's banks and savings associations. We, of course, need a regulatory structure in which the Congress, the industry, and, importantly, the American public have confidence. Such a structure would permit the rationalization of some of the more burdensome compliance provisions Congress felt compelled to impose on our industry.

In our discussions of the issue of bank regulatory structure, it quickly became apparent that the issue of reform is highly complex. Its complexity reflects, in large part, deeply held and often disparate views regarding the proper regulation of banks and bank holding companies by the States and the Federal Government. Many of these views are perfectly valid, but they also are very difficult to reconcile. Examples of such views are: The need to have different Federal regulators for Federal and State banks in order to foster the innovation that is a hallmark of our dual banking system; the need to have our central bank—the Federal Reserve System—meaningfully involved in bank supervision because of the vital role the banking system plays in ensuring economic growth and stability; the need for some element of accountability to the Executive Branch of our Government, while insulating regulators from political influence; and the need for smaller, State nonmember banks to have their own knowledgeable Federal regulator.

These pre-existing views make it impossible to start with a clean slate and draft an elegant new regulatory structure. In order to move forward, therefore, we must

be able to distinguish between what is critical to our present structure, and what can and should be changed.

Six Principles for Regulatory Reform

As a first step toward reshaping the current banking regulatory and supervisory structure, The Bankers Roundtable has established a set of principles that reflect our membership's concerns and objectives. I have already stated our first principle, which is that the status quo is unacceptable and that we welcome this effort by the Committee to craft a new structure.

Second, The Bankers Roundtable believes that significant administrative efficiencies can be achieved through regulatory reform and we hope that it may be possible for all of the parties involved—the Congress, the Administration, the regulators, and the industry—to find ways of achieving those efficiencies. The Bankers Roundtable looks forward to participating in that process.

Third, we believe that reform of the Federal banking regulatory and supervisory system should lead to reduced costs in banking regulation while improving the effectiveness of the bank regulatory and supervisory system.

Fourth, we believe the Federal banking regulatory and supervisory system should be revised in a way that ensures an appropriate balance between the surviving Federal agencies and our system of State and Federal regulation.

Fifth, we believe there should be a continuing role for State bank supervisors, for the Comptroller of the Currency (or a new Federal Banking Commission (FBC)) and for the Federal Reserve.

Finally, we believe that any new Federal bank regulatory agency, in both its design and operation, should be insulated from political forces to the maximum extent possible.

The Bankers Roundtable commends to the Committee Members these important principles.

Some Possible Approaches

With the principles we have outlined in mind, I would like to address their implications for some of the key elements of the regulatory reform proposals now under consideration.

First, like others, we think it is clear that the Office of Thrift Supervision (OTS) should be merged with the OCC, presumably to form a new, independent Federal Banking Commission (FBC). Indeed, we believe that there is near, if not complete, unanimity on the desirability of this step. There should not be a merger, however, of the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF).

Another step that we think clearly is desirable, and we think most others also recognize to be desirable, is the removal of the Federal Deposit Insurance Corporation (FDIC) from its current role as primary Federal supervisor of State nonmember banks. This would eliminate the inherent conflict of interest that the FDIC currently faces as both a regulator and an insurer. The FDIC's regulatory and supervisory authority should be reduced to backup authority in troubled or failing institutions.

In moving beyond these initial two steps, however, we recognize there is less agreement on what should be done to restructure the regulatory process. Nonetheless, there may be some additional areas where real progress could be made and where agreement may now be achievable.

Clearly, duplication and redundancy of examinations by regulatory agencies should be eliminated. A logical step in this direction would be to ensure that each bank holding company (and its subsidiaries) be primarily responsible to only one Federal banking agency with examination and supervisory authority.

The appropriate roles for the principal Federal banking agencies, as well as for State agencies, also need to be addressed. These matters, however, are highly complex and require careful analysis, given the nature of the U.S. system of State and nationally-chartered banks.

We believe there should be a continuing role for both the Federal Reserve and a Federal Banking Commission in banking regulation and supervision. The Federal Reserve should retain its current role as the rulemaking authority for bank holding companies. The Federal Reserve should also have regulatory responsibility for a sufficiently large number of representative banks to enable it to carry out its roles in monetary policy, the economy, and the payments system most effectively. The extent of the Federal Reserve's supervisory and examination authority over individual banking companies should be determined on the basis of criteria for those companies such as their:

(1) size and geographic location;

(2) importance to international, national, regional, and local economies;
(3) role in the payments system;
(4) nature of nonbank activities; and
(5) charter.

Finally, and certainly not to be ignored in the present debate, is the crucial issue of a single Federal regulator. Our membership feels very strongly that there are major problems and disadvantages in such an approach. Other steps could be taken short of that which would represent real progress—real progress we should be able to make now. I hope we do.

An Even More Important Step

While the Roundtable's members are anxious to see progress made in the area of regulatory consolidation, we believe, as noted earlier, that an even more important step is the modernization of the basic laws under which our Nation's financial institutions operate. As is the case with our current regulatory structure, these laws were crafted at another time to address another set of problems. Just as our regulatory structure is out of date and ill-suited to today's marketplace, so too are the Bank Holding Company Act and the Glass-Steagall Act.

We would hope, therefore, that the Committee not lose sight of the need for appropriate changes to our basic banking laws. For example, we would urge the Committee to streamline the procedures for bank holding companies to engage in new nonbanking activities; to create a standard for permissible nonbanking activities that acknowledges the integration of financial markets, the impact of technological developments and new competitive realities; and to revise the cross-marketing rules to enable institutions to market products and services more efficiently to customers.

Thank you for the opportunity to appear here today.

PREPARED STATEMENT OF JAMES E. GILLERAN

ON BEHALF OF

THE CONFERENCE OF STATE BANK SUPERVISORS

Thank you, Mr. Chairman and Members of the Committee. I am Jim Gilleran and I am the Superintendent of Banks for the State of California. I am testifying today on behalf of the Conference of State Bank Supervisors where I serve as Chairman. I appreciate the opportunity to discuss with you the issue of restructuring the Federal bank regulatory agencies.

The Conference of State Bank Supervisors is the professional association of State officials that charter, examine, supervise, and regulate the nearly 7,700 State banks. We work in cooperation with the Federal Deposit Insurance Corporation and the Federal Reserve System, which provide Federal oversight of State banks.

Restructuring the Federal banking agencies will have a profound impact on the regulation of State-chartered banks and on the dual banking system. As you know, State bank supervisors work closely with the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve System (Fed) in supervising State banks and their holding companies. Through these cooperative efforts, the State banking system continues to lead other types of depository institutions in all measures of safety and soundness such as capital ratios and failure rates.

At the end of the third quarter, State banks held $1.57 trillion in assets and $1.15 trillion in deposits. State banks as a whole continued to be well capitalized and profitable. State banks have an aggregate capital ratio of 8.14 percent. This rate compares favorably to the 7.8 percent capital ratio of national banks. Only 41 banks failed in 1993. Failed State banks made up 18 of this total. This brings the failure rate for State banks below the one quarter of 1 percent mark, the lowest it's been in 10 years. We have no reason to believe that the downward trend in State bank failures will not continue (See Attachment A). Throughout the turbulent 1980's, fewer State banks failed and those that did fail cost the FDIC less than their federally-chartered counterparts.

Because of the significant impact of agency restructuring on the financial system, any reform must be approached with caution. Any proposed structure must be thoroughly studied to assure it meets the goals of restructuring, while not resulting in unintended consequences that may severely impact our financial system. This endeavor does not entail simply moving boxes around on a chart. The resulting supervisory system will dictate both the soundness of the industry and the industry's ability to meet future challenges and competition.

Over the last 50 years, numerous recommendations have been proposed by various Presidential commissions, private sector groups and elected officials, each advancing a different bank regulatory structure. We have attached a chart highlighting the recommendations of each (See Attachment B). This chart shows that while there has long been a consensus that regulatory restructuring of the banking industry would be beneficial, there has not been a consensus on the best way to achieve this end.

In restructuring the Federal banking agencies, the resulting system must meet three goals. First, any new system must improve the supervision of depository institutions. Second, the restructuring should eliminate unnecessary overlapping responsibilities. Finally, the structure chosen must create an environment of creativity and responsiveness for both the institutions and the supervisors. While easy to state, these goals prove much more difficult to achieve.

In addition, several constraints face any restructuring proposal. Any restructuring proposal should not place greater risk on the deposit insurance system or on the payment system. The Fed's ability to conduct monetary policy must not be hindered. Finally, any restructuring proposal should not damage the dual banking system.

A number of witnesses will discuss the impacts of various restructuring proposals on the payment system and on the conduct of monetary policy. Rather than rehash these arguments, I would like to focus my comments today on the remaining two concerns: The dual banking system and the deposit insurance system.

The term "dual banking" is used to describe a unique manifestation of federalism that exists in our financial system. Like many terms, dual banking means different things to different people. At its core, dual banking entails the States and the Federal Government independently chartering, examining, and supervising banks. It also incorporates the concept that banking institutions can freely choose between a State or national charter. The national banking system and the State banking system have characteristics that meet various needs of institutions. As these characteristics change or as the institutions change, banks will convert to the other charter type.

What are some of these characteristics? For national banks, the primary feature of their charter is uniformity. Although there are occasional regional variations in the Administration of the rules and procedures, an Office of the Comptroller of the Currency (OCC) ruling applies equally to all national banks regardless of their location. In addition, certain State laws are overridden by the National Bank Act, allowing national banks to engage in activities prohibited to State banks under State law. The best example is national bank sales of insurance in small towns regardless of State law to the contrary.

The characteristics of the State banking system derive from its local orientation. State bank superintendents focus primarily on local needs and conditions. This allows the States to be more responsive and flexible. Simply put, many banks in California prefer to deal with my office in San Francisco rather than the OCC office in Washington. I regulate 252 State-chartered banks in California. I can tailor solutions to meet specific problems that the OCC may not be able to address on a local basis. In addition, this gives me the opportunity to better understand the banks and the communities they serve. With 4,000 banks nationwide, the OCC cannot possibly reach this level of understanding.

Because of the State banking system's local orientation, numerous innovations have been developed. These innovations encompass developments in products and services as well as supervisory techniques. Many of these have been adopted for all depository institutions. In this way, the State banking system acts as the laboratory for innovations consistent with the role for the States in our system of federalism.

One of the critical aspects of the dual banking system is the role of the Federal Government in State-chartered banks. The primary focus of Federal oversight is to protect the deposit insurance system. The appropriate Federal regulator, the FDIC for State nonmember banks and the Fed for State member banks, conducts examinations aimed at achieving these objectives. In addition to examination authority, the FDIC has a number of other tools to protect the deposit insurance funds from potential undue risk from State institutions. These tools include granting and removal of deposit insurance and approval of certain State bank powers.

In order to assess the impacts of various restructuring proposals on the dual banking system, CSBS identified seven criteria. These criteria set out the issues in restructuring that have the potential to severely damage the dual banking system. I wish to take a moment to describe each of the seven criterion, then apply them to the major proposals being discussed.

The new system must not place the Federal oversight of State institutions, including Federal rule-making, with the same agency that charters Federal institutions. This criterion addresses the concern that the State banking system

cannot survive being regulated at the Federal level by the same institution that charters, supervises, and examines national banks. We are concerned that the institutional bias of the Federal chartering agency will eliminate all the flexibility inherent in the State banking system. We do not believe that there is an effective legislative or structural protection against the Federal chartering agency preferring the institutions it charters over State institutions. The recent example of placing the Federal oversight of State savings associations at the Office of Thrift Supervision (OTS) shows the danger of this structure to the State banking system. Since 1989, the State savings associations have faced triple regulation by the State, the OTS, and the FDIC. During this same period, the number of State thrifts dropped dramatically as healthy State thrifts converted to bank, savings bank, or Federal savings association charters. The State savings association charter is no longer a viable option. If State banks are subjected to Federal oversight by the same agency that charters national banks, the viability of the State bank charter will be eliminated and the dual banking system will cease to exist. Preserving the dual banking system should be one of your primary goals.

The new system must provide that the agency that administers Federal deposit insurance is not the same agency that charters institutions. The glaring lesson of the thrift debacle was the need to separate the agency that charters institutions from the agency that provides deposit insurance. The concerns of the chartering agency with economic development, credit provision, and other policy initiatives are from time to time at odds with the need to protect the deposit insurance fund. For example, under the Federal Home Loan Bank System, the desire to maintain a thrift industry to provide mortgage credit overwhelmed the need to close failed institutions to protect the insurance fund. In order to avoid having the interest in protecting the deposit insurance fund subordinated to the broader policy goals of the chartering agency, an independent agency must retain control over the granting and withdrawal of deposit insurance.

The new system must not impose new fees on State-chartered institutions. Currently, both State banks and national banks pay two fees. The first is a fee to their respective chartering agency. The second is deposit insurance premiums paid to the FDIC. Any new regulatory scheme must not result in an additional fee on State institutions. This new fee is simply a discriminatory tax on State chartering. The State savings association example where State thrifts must pay an additional fee to the OTS points out the devastating impact of these fees on the viability of a State charter.

The new system must encourage States to act as laboratories for innovation in new bank products, services, and supervision. The value of the dual banking system is to permit innovation and experimentation. Without State innovations, the banking industry and supervisory system will grow stagnant and unable to meet future challenges. In addition, restricting State flexibility will result in the removal of the ability of institutions to meet local needs and conditions. Any new system of Federal regulation should not only permit State innovation, but also promote local solutions and experimentation.

The new system must provide a real choice between State and Federal charters and regulatory systems. In order to maintain the benefits of the dual banking system, the decision of what charter to operate under must entail the weighing of different advantages and disadvantages. If the exact same rules apply and are administered by the exact same agency, no choice exists. The same rules also mean a one size fits all approach that does not take into account the vast differences in local needs. Without a real choice, the dynamic that provides innovation in supervision and acts as a check on excesses is destroyed. The State charter will be in name only.

The new system must maintain the checks and balances in bank relation between Federal bank regulators and between Federal and State bank regulators. The current Federal bank regulatory scheme can become extremely frustrating, especially for those who wish to make substantial changes quickly. However, given the importance of depository institutions in our economy, radical changes in policy direction can result in unintended and unseen consequences. It is important that a system of checks and balances be put into place to air the potential impact of policy changes by the regulators. Eliminating checks and balances cannot be a goal of reinventing Government. Checks and balances are not inefficiencies but are vital to democracy and vital to a healthy economy. Currently, multiple Federal agency rule-making provides this balance. Any reduction of multiple agency rule-making must be accompanied by another effective method of checks and balances.

The new system must ensure political independence of the Federal banking agencies. Any regulatory structure should insulate bank regulators from political pressure that may compromise independent judgment on matters of safety and

soundness. While the need for political independence is clear, how to achieve it is less so. In our view, political independence is less a matter of who makes an appointment than the ongoing influence over agency activities. Where a single individual heads a bank regulatory agency, that individual must be protected from removal for political reasons. Similarly, an agency headed by a board or commission should limit the number of members of the board or commission that lack independence. Our preference is for members of the board not to be "at will" political appointees as either primary or ex-officio members.

It is critical to the dual banking system that the restructuring of the Federal banking agencies meet all seven criteria. We do not believe that these criteria are in conflict with the goals of restructuring. In fact, a number of restructuring alternatives can achieve these goals and not destroy the dual banking system.

Determining the impact of a regulatory restructuring proposal on the dual banking system requires comparing the proposal to the seven criteria. In the interest of time, I will not discuss each of the three proposals in-depth. Other witnesses have described these plans in great detail.

The Treasury plan calls for merging the supervisory functions of the OCC, OTS, FDIC, and Fed under the new Federal Banking Commission (FBC). The Commission would charter Federal institutions, provide Federal oversight over State institutions and supervise all holding companies. The proposal grants new broad supervisory and examination authority to the FBC over State banks. To the extent that we know the details of this proposal, it violates five of the seven criteria.

The FBC would both charter national institutions and supervise State banks. Further, additional fees on State banks will be required to fund this new agency. It is unclear how the FBC would provide State institutions any flexibility for State innovation and creativity. The structure would eliminate any differences between State and Federal charters. No real choice is retained. Also, the FBC receives all rulemaking authority without a countervailing system of checks and balances.

The proposal does maintain the separation of the deposit insurance function from chartering. It also provides an enhanced degree of political independence for the chartering agency of Federal institutions. However, it stops well short of providing both the FBC and the FDIC with substantial independence from political influence.

The current Treasury proposal will destroy the dual banking system. For this reason, CSBS is opposed to the proposal in its current form. We have met with a number of Administration officials to work toward a plan that meets the goals of restructuring and preserves the dual banking system.

S. 1633, introduced by Chairman Riegle and Senator D'Amato, is substantially similar to the Treasury proposal. It would also create a single Federal banking agency. It does provide greater political independence for the Federal Banking Commission. In all other respects, it is very similar to the Treasury proposal.

By creating a single Federal banking agency to charter Federal institutions and supervise State institutions, S. 1633 will destroy the dual banking system. We urge Chairman Riegle and Senator D'Amato to review S. 1633 and adopt changes to avoid this result. While we oppose S. 1633 as currently drafted, we look forward to working with its sponsors to develop a restructuring plan that we can all agree upon.

Governor John LaWare of the Federal Reserve Board has offered an alternative. Under this proposal, the Fed would regulate all State banks and their holding companies. The OTS and OCC are merged to form a separate agency (FBC) with responsibility for chartering and examining Federal institutions and their holding companies. The FDIC continues as an independent agency providing deposit insurance. In addition, the Fed would retain additional supervisory responsibility over an unspecified number of significant institutions.

The LaWare plan provides a reasonable alternative to the Treasury proposal and S. 1633. It reduces the number of Federal banking agencies with direct supervision responsibilities from four to two. It provides for reduced overlapping responsibilities and has the potential for improving the oversight of depository institutions. It also creates a system that includes a dynamic element to promote innovation and creativity by retaining a countervailing regulator to the FBC. This structure does not reduce the Fed's ability to conduct monetary policy or to administer the payment system.

Comparing the LaWare plan to the seven criteria for the protection of the dual banking system is somewhat difficult because we have not seen legislative language. It appears from the information available that the plan generally meets at least six of the seven. The one remaining question of the LaWare plan concerns the regulation of holding companies.

Under this proposal, the Federal regulator for the holding company is determined by which agency regulates the lead bank in the holding company. Where the lead bank is national, the FBC would be responsible for regulating the holding company.

If the lead bank were State, the Fed would be the Federal agency to oversee holding company activities. To the extent that this oversight extends to the holding company and its nondepository affiliates, we support this concept as reducing unnecessary overlap.

The LaWare plan provides that the Federal agency that is responsible for the lead bank is responsible not only for the holding company and its nondepository affiliates, but also for all the depository affiliates as well. This results in the FBC supervising State banks, violating the first criterion.

Before closing, I would like to discuss two other issues. First, is the concept of certifying State banking departments to reduce or eliminate the need for Federal bank agency oversight of State banks. Currently, States work with the Fed and the FDIC on an alternating year basis. Under certification, the Federal presence in State banks will be reduced for approved States.

This concept, not surprisingly, is of great interest to the State banking departments. States are certified by the Federal Government to perform numerous functions. Certainly, bank regulation is one area where there is great potential for overlapping State and Federal capabilities. The questions, as always, are in the details of a certification program. Certain questions will arise that need to be addressed. Will States be certified for safety and soundness or compliance, or both? Will States be certified for all State banks or only those below a certain size? Will some States be certified for larger banks and others for smaller banks? What are the criteria for certification and who determines certification?

CSBS accredits State banking departments. This procedure requires an in-depth self-evaluation and a two-tiered review by outside experts. To date, CSBS has accredited 29 States which regulate over 80 percent of the assets of all State banks. I have attached a description of this program to my testimony (See Attachment C).

One of the key issues in certifying States is who will make the decision to certify an individual State. The outcome of this question depends on the final form of restructuring. The State bank supervisors are strongly opposed to placing the certification decision at the FBC or any agency that also has primary responsibility for chartering and supervising Federal institutions.

The final issue I wish to address is the role of the FDIC in any restructuring plan. The primary role of the FDIC today is the protection of the deposit insurance system. This role must be protected in any restructuring scheme. Over the years, the combination of State supervision with FDIC oversight has produced sound banks that are able to weather financial turmoil. By providing separate oversight from both the chartering agency and the deposit insurer, the State banking system has remained strong.

The proposals I have discussed today all result in a significant reduction in the role of the FDIC in examining and supervising banks. This reduction in the FDIC's role and its responsibility under a new structure requires careful study. All of the proposals call for FDIC involvement in problem institutions. But none describe this involvement in any detail. In addition, the FDIC Board must be restructured to assure its independence. If a single regulator plan is adopted such as that proposal by Treasury, the Chairman of the FBC should not sit on the FDIC Board. We recommend that under any restructuring, the FDIC be reduced to three public members, eliminating the seats currently held by the OCC and the OTS.

The role of the FDIC requires your attention. We are concerned it has been lost in the debate of the role of the Fed and the other issues surrounding regulatory restructuring. Having just survived a substantial threat to the solvency of the Bank Insurance Fund, it would be a tragedy to place the FDIC at risk in an effort to clean up an organizational chart. The taxpayer must ultimately bear any mistake made in reducing the FDIC's authority. We urge you to move with great caution in this area.

In conclusion, I would like to restate our view that in restructuring the Federal banking agencies it is possible to meet the goals of restructuring while preserving the dual banking system, the monetary and payment system, and the deposit insurance system. We do not believe this is accomplished by the Treasury proposal or by S. 1633. We believe the LaWare plan goes a long way toward achieving this objective. There are other approaches to restructuring that also meet the objectives of restructuring the Federal banking agencies.

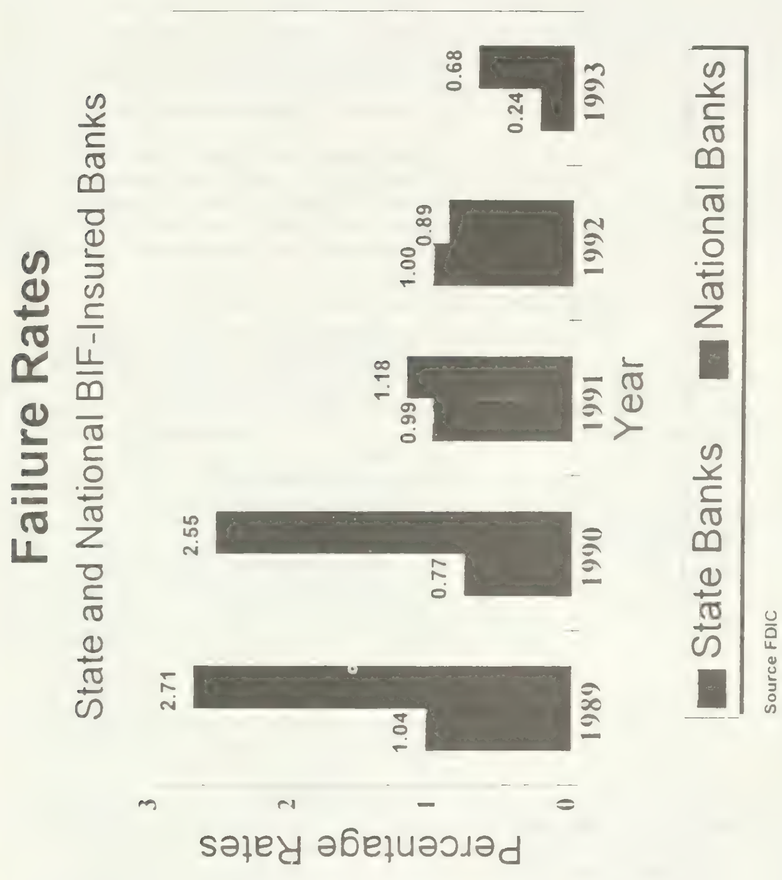
Bank regulation is unique. The power of bank regulators exceeds that of Government officials that regulate other industries. In many cases, the due process protections that shield other industries from regulatory excess are not present in bank regulation. The absence of these protections requires another mechanism to prevent abuse. Providing a real choice between bank charters is the best substitute.

We commend the Members of this Committee for the time and effort you have already put into this issue. Also, the Administration has dedicated significant time

and effort to its restructuring plan. We strongly urge the Members of this Committee to engage in a meaningful dialogue in an effort to find an appropriate restructuring plan. We are willing to work with you to design a restructuring plan. We are dedicated to being a positive voice in this debate.

I will be happy to answer any questions you have at the appropriate time. Thank you.

ATTACHMENT A



ATTACHMENT B

PRIOR REGULATORY RESTRUCTURING REPORTS

REPORT	RECOMMENDATIONS
The Hoover Commission (1949)	President Truman's Task Force on Regulatory Commissions recommended that all federal bank supervision be combined, preferably in the Federal Reserve.
The Commission on Money and Credit (1961)	Private study group which recommended that the supervisory functions of the OCC and the FDIC be transferred to the Federal Reserve.
The Hunt Commission (1971)	Presidential Commission which recommended creating an "Administrator of National Banks" to assume the OCC's responsibilities; an "Administrator of State Banks" to assume the Fed's and FDIC's supervisory responsibilities; and a "Federal Deposit Guarantee Administrator" to assume the FDIC's insurance functions.
The F.I.N.E. Study (1975)	House Banking Committee Study which recommended combining the supervisory and examination functions of the FDIC, Fed, OCC, FHLBB and the NCUA into the "Federal Depository Institutions Commission".
The Grace Commission (1983)	Private Sector Study commissioned by President Reagan which recommended consolidation of the OCC, FDIC and the Fed into a Federal Banking Commission.
Blueprint for Reform (1984)	The Task Group on Regulation of Financial Services, chaired by Vice-President Bush, recommended replacing the OCC with a Federal Banking Administration for regulation, supervision and examination of all national banks and holding companies with a lead national bank; placing federal regulation of all state-chartered banks and their bank holding companies under the Fed; eliminating FDIC bank regulation and supervision but enhancing FDIC authority as insurer; and retaining the dual banking system.
Modernizing the Financial System - Recommendations for Safer, More Competitive Banks (1991)	This Treasury study recommended replacing the OCC and OTS with a Federal Banking Agency; having the Fed regulate all state-chartered banks while rescinding Fed authority over national banks; and relieving the FDIC of its regulatory and supervisory responsibilities while empowering the FDIC to analyze broader powers for state banks.

ATTACHMENT C

THE CSBS ACCREDITATION PROGRAM

The CSBS Accreditation Program evaluates state banking departments to ensure that they are able to meet their public responsibilities efficiently and effectively. Accreditation is an ongoing process that requires annual reviews to assure that the department continues to maintain the highest possible standards of bank supervision and regulation. The program is voluntary.

The CSBS Accreditation Program recognizes differences among state banking departments and does not require the departments to adopt uniform regulatory, supervisory or management practices. This flexibility allows each of the banking departments to pursue its goals and public interest responsibilities while establishing basic standards of competency and professionalism.

The goals of the CSBS Accreditation Program are: (1) To provide guidance and assistance to state banking departments through self-evaluation and self-improvement (2) To provide independent evidence to the state government administration, legislature and public of the capability of an accredited state banking department (3) To assist each department with documentation in obtaining the resources necessary to assure the safety and soundness of state banks.

STEPS IN THE ACCREDITATION PROCESS

1. The state banking department completes a Self-Evaluation Questionnaire and submits a request for accreditation review to the CSBS Performance Standards Committee (PSC). The PSC is a permanent standing committee of CSBS whose membership includes current and former state and federal regulators, and bankers with extensive bank regulation knowledge.

2. The PSC assembles a Review Team to conduct an on-site evaluation which encompasses examination of bank examinations, work sheets and enforcement actions. A Review Team consists of three people with extensive experience in bank regulation, typically including at least one current or former state bank regulator, and one or two current or former regulators from the FDIC, the Federal Reserve or the Office of the Comptroller of the Currency. At the conclusion of the on-site review, the Review Team conducts an Exit Interview with the head of the banking department to discuss the Team's findings and to afford the department an opportunity to respond.

3. The Review Team submits its findings in a written report to the PSC. The PSC then assembles an Audit Team which audits the procedures employed by the Review Team. Like the Review Team, the Audit Team typically consists of three members who are current or former bank regulators from the state and federal regulatory agencies.

4. PSC members analyze the Review Team report and the Audit Team findings to make a final decision on accreditation. PSC members vote on whether to accredit the department.

5. Accreditation is contingent upon the successful completion of periodic reviews acceptable to the PSC and full re-accreditation by the PSC not more than seven years from the initial accreditation.

PREPARED STATEMENT OF JOHN SHIVERS

ON BEHALF OF

THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. Chairman, I am John Shivers, Chairman, President, and CEO of Southwest Bank, Fort Worth, Texas. I am also President of the Independent Bankers Association of America, which is the only national trade association that exclusively represents the interests of community banks. We appreciate the opportunity to testify regarding legislation to consolidate the bank regulatory agencies.

We have followed this debate very closely and were invited to meet with Treasury officials and the Comptroller of the Currency on the Treasury proposal. We have also met with Chairman Greenspan.

There is a fundamental difference between the Treasury approach and the approach of the Federal Reserve. The Treasury apparently is continuing to insist on a single regulatory agency while the Federal Reserve insists on maintaining a hands-on examination role over banks of all sizes.

We cannot support the Treasury's approach since it violates three basic principles which we are using to evaluate any proposal.

Three Principles for Agency Consolidation

The principles are:

Preservation of the dual banking system;

Preservation of the Federal Reserve's role in bank regulation;

and

Preservation of choice in regulator.

Preservation of the Dual Banking System

The dual banking system is one of the linchpins of our banking system. It has been the test laboratory for NOW accounts and variable rate mortgages, among others. These innovations have served the banking industry as well as consumers. A single, monolithic Federal regulator that is also the charterer of national banks and Federal savings associations would have a built in bias toward those federally-chartered institutions and their powers and obligations. This would severely restrict the ability of States to act as laboratories for banking innovation because the powers to be exercised and obligations to be met would not be Federal powers and obligations.

State laws defining banking powers and obligations are tailored by each State to the individual needs of the State. The banking climate, due to economic, geographic, and demographic differences is very different in California, North Dakota, and Texas. If the dual banking system were dismantled, a Federal regulatory system that fails to account for these differences would cause bank regulation to be at the lowest common denominator, and thus unable to adequately adapt to local conditions.

Preservation of the Federal Reserve's Role in Bank Regulation

The Federal Reserve needs to remain a bank regulator for several reasons. Most importantly, having two hands-on regulators preserves vital checks and balances. The Federal Reserve put a brake on the lax supervisory practices being promoted by Treasury Secretary Donald Regan and his Comptroller of the Currency, C. Todd Conover. Today, the Federal Reserve is playing a very valuable role in independently considering the desire of this Administration to use banks to promote social policy goals. There are legitimate questions raised, including safety and soundness questions, when banks are placed at the forefront of such efforts and when bank competitors such as credit unions, mutual funds, and securities firms are not so obligated.

The maintenance of at least two Federal regulators would smooth out the politicization of regulation from both the liberal and the conservative point of view, depending on who is in the White House, and this would enhance financial stability.

It is critical that the Federal Reserve's role as a regulator include the regulation of banks of all sizes, and not just the largest banking companies. Our banking system is made up of vastly divergent types of banking entities: International banks, multi-regionals, community banks, agricultural lenders, small business lenders, and consumer lenders, to name some. They are all part of an interlocking grid that provides financial services to most Americans and to most American business.

The agricultural economy has historically been volatile, as evidenced by the last decade, which had a great agricultural boom in the early 1980's, followed by the agricultural crisis of the mid-1980's. It is critically important that the Federal Reserve have as much first hand knowledge of the condition of the agricultural economy as

is possible in order for it to properly execute its duties with regard to the economy. Because most community banks are either involved in agricultural lending or are situated in areas where the local economy is dependent on agriculture their fortune of is closely tied to the agricultural sector. The Federal Reserve's hands-on examination of these institutions gives it critical information about the agricultural economy that is necessary to carry out these duties.

If the Federal Reserve does not have access to all sectors of the banking industry, it will not have a hands-on grasp of the whole economy. Because banks are inter-related through correspondent relationships, what happens at one institution can affect many. In addition, a crisis of confidence in one sector of the banking industry will affect public confidence in all aspects; the public tends to view the industry as one, and not as different, though inter-related, entities. Therefore, it is critical that the Federal Reserve continue to regulate a broad spectrum of banks. We cannot afford the risk that a crisis could be exacerbated because the Federal Reserve did not have a hands-on knowledge of a broad spectrum of the banking industry.

Third, the banking system has risks that are built in. Every loan carries some risk. When banks become too risk averse because of fear of regulatory action, a credit crunch is induced as we recently have seen. Because a monolithic Federal regulator would have a narrow point of view with regard to its duties, i.e. safety and soundness, and since it would have no macroeconomic responsibilities, its bias would be to push for too little risk in the system. This would have the effect of having a long-term bias against risk-taking. The Federal Reserve, because it also has macroeconomic responsibilities, must balance the risk inherent in banking with encouraging the provision of enough credit so that the system works. Thus, the retention of the Federal Reserve in the bank regulatory arena helps to insure a balance between limiting risk and ensuring adequate credit for economic growth.

Fourth, The Federal Reserve needs hands-on experience and interaction with the banking industry to effectively manage monetary policy and deal with financial crises. The Treasury Department has said that under its proposal the Federal Reserve would have a seat on the board of the Federal Banking Agency and would have access to all Reports of Examination. This, however, is not enough for the Federal Reserve to effectively manage monetary policy and deal with financial crises.

Bank examination reports only show the financial condition of a bank at a particular point in time. Monetary policy and the handling monetary crises requires much more information than the condition of the bank. It requires that the Federal Reserve know how individual banks operate in the marketplace, what individual banks are capable of doing, and how these factors and the Federal Reserve's resources can best be combined to reach the necessary result. We do not believe that the Federal Reserve would have been anywhere near as successful in handling the 1987 stock market crash if it did not have the hands-on expertise that it had. To remove the Federal Reserve from its role as regulator without absolute assurances that its ability to react would not be impaired in any way would be the height of folly.

Proponents of a single regulator criticize delays when the banking agencies work to adopt uniform rules. These critics apparently believe that adoption time, and not the quality of the rule, is the paramount consideration. But it is the quality of the rule that is most important. Having more than one regulator brings innovation, new and diverse ideas, and a flexibility to consider alternatives that would not exist with a single regulator.

An example of this is the process the three banking agencies used to write their first major joint regulation. In 1985 the agencies issued the first joint capital definition. When the project was begun, each agency had vastly different capital definitions, with the differences centered mainly in the area of the treatment of intangibles. The definition that each agency used was one that had been developed over a long period of time, and the corporate culture of each agency dictated that its definition was the best. Because the regulators from each agency were sitting across the table from peers, they had to listen and consider the arguments presented for altering their capital definition.

This interplay would not occur if there was a monolithic regulator because there would be only one corporate culture, one way of doing things. With no peer having a different way of looking at things there would be less flexibility and a lesser ability to react to the changing financial services marketplace. This would work to the detriment of the safety and soundness of the banking system.

Having different corporate cultures at the Federal level works much the same way that the dual banking system works. It insures that different ideas will be considered by the Federal bank regulatory authorities.

Preservation of Choice in Regulator

The preservation of choice in a Federal regulator is important for the banking industry. I doubt whether the Members of this Committee fully realize the power regulators have over our professional lives. After the examiners are finished, they or their peers judge us and carry in their back pockets a full array of possible penalties ranging from higher insurance premiums to civil money penalties and, in rare instances, criminal penalties. And again, in some cases—and there have been more of these cases in the recent history of Texas than I care to remember—the regulators have the power to close the bank and insure that its former managers are forever banned from banking. And all without a trial. Due process is lacking in our regulatory system and in such a system there is a crucial ongoing need for checks and balances. The ultimate balance is an open door to change regulators. In this connection please remember that examination is a highly subjective process and bad chemistry with regulators over time can have disastrous consequences. The door to change must be kept open.

Experience shows us that bank regulation can be overly strict, such as was seen recently, especially in New England during the credit crunch. There examiners engaged in excessive criticism of asset quality, inhibiting banks from lending. This harmed both the industry and the economy. And in such a climate more than one regulator can mitigate regulatory overkill. I believe Mr. Chairman, that you singled out Bob Clarke for producing such regulatory overkill. Under the single regulatory agency proposal Bob Clarke and his peers at the Treasury Department would have set the rules without recourse.

It has been noted by advocates of a single regulator that there are single regulators for all other industries. For example, the SEC regulates securities firms. Therefore, it is argued that there should be no difference for the banking industry.

This argument fails to take into consideration the crucial difference between bank regulation and all other Federal regulation. Banking is the only industry where Federal regulation is so pervasive as to affect all aspects of the business. There is no other industry where permission must be received for doing virtually anything, where regular examinations are performed, and where the Federal administrative enforcement power is so pervasive and powerful.

Securities firms are regulated by self-regulatory bodies in addition to the SEC. Therefore, there is some availability of regulatory choice. Furthermore, the SEC does not examine securities firms in the same manner that the bank regulatory agencies regulate banks. Finally, the SEC does not have enforcement authority that is as broad as that enjoyed by the bank regulators.

Governor Branstad of Iowa, writing on behalf of the Nation's Governors, has written that "[A]ny legislation should allow for banks to make a choice as to which Federal regulator is in their best interest." A copy of that letter is attached to this testimony as Exhibit A.

Overlap and Inefficiencies in the Current System

We concede that there are overlaps and inefficiencies in the current system. We also believe that there is enormous overregulation in the current system and this will only be resolved if Congress changes the laws triggering this overregulation. In passing new laws, has the old maxim been forgotten: "It was the straw that broke the camel's back." Well, community banking's back is being broken by the application of laws meant for far larger banks. Examiners today are demanding branch closing policy statements for banks that don't have branches. Today's community banker knows that when he opens his door for business every day that, in the course of the day, some regulation will have been broken and if there is a White Glove examination, the banker will be gigged. Regulatory consolidation will not solve the problem of too many laws written for much larger institutions.

There are too many examiners. Examining forces are staffed to levels needed to deal with hundreds of bank failures and thousands of problem banks. This is not today's banking world. An examiner wrote us that he witnessed an examiner breaking into tears upon learning that a community bank had been merged. Examining this bank was his only job. All the agencies should pare back their staffing now.

There also seems to be full agreement that every banking institution should be examined by only one Federal regulator. One does not have to create one enormous, bureaucratic Treasury-controlled Federal Banking Commission to accomplish this desirable end.

Consolidation that is Necessary Today

The IBAA believes that the only regulatory consolidation that should be undertaken is the merger of the OTS and the OCC. We do recognize that the debate may

have gone beyond this historic proposal to merge the supervisor of national banks with that of the thrifts.

As the debate has gone forward we have regretted that no powerful voice has urged the maintenance of an FDIC with a substantial primary examination authority over State-chartered banks. It does appear that there is now a mood to tear asunder this agency just as there had been a mood to substantially increase its powers when Congress was considering FIRREA and FDICIA and when Chairman Seidman was urging such new powers.

What has the FDIC done to warrant its proposed new fate? It has operated admirably in light of the decision by the Clinton Administration to keep the seat of the chairperson empty for so long. We really did not expect Ricki Tigert to break with the Administration's proposal, but we do believe that Ms. Tigert would be up to the job if the Congress decides not to strip this agency of its primary examination function over State-chartered nonmember banks.

Since the FDIC does lack a champion in Washington today—we still hope that one will emerge on this Committee—we are somewhat resigned to its primary examination functions being dispersed either to the new Federal Banking Commission and/or to the Federal Reserve. If that is the will of this Committee, we strongly urge that bankers continue to have regulatory choice and that bank examination fees and Federal Reserve membership requirements be carefully reviewed to ensure that there are no perverse incentives affecting banker choice.

Politicizing of Bank Regulation

The Administration proposal would have the Secretary of the Treasury on the Board of a monolithic Federal Banking Commission. This would inject the political process much too deeply into the bank regulatory process.

Any Secretary of the Treasury worth his salt would control this Board, plus delegating the running of it to trusted lieutenants. The terms of the Board members in turn is too short and too close to the term of the President to ensure meaningful independence. If this Committee does authorize a Federal Banking Commission of more limited scope—consistent with the principles I have enumerated—we strongly recommend a Board with a different structure and substantially different terms of office.

Conclusion

There is merit to considering some changes in the Federal bank regulatory scheme. However, we must be careful not to destroy the good parts of the current system just because of a desire for change. Any changes should be made in consonance with the IBAA's three principles: ***Preservation of the Dual Banking System, Preservation of the Federal Reserve's Role,*** and ***Preservation of Choice.*** To act otherwise raises the real possibility of seriously harming the safety and soundness of a system that has served this Country and its citizens well for a long period of time.

Our banking industry is the envy of the world. Others are seeking to emulate it. It is innovative, remarkably free of corruption, and helps sustain the most dynamic economy in the world. It sustains the strongest small business structure in the world. It is a highly diversified structure and in this diversification lies its strength. The diversified regulatory structure mirrors the diversity of the industry. Changing the regulatory structure—concentrating the regulatory structure—will, over time, adversely impact on the remarkable diversity of our industry. We have all heard that Japan, Germany, Canada, and the U.K. have single agency structures and that this should be our model. Look at their economies and unemployment rates. This should be reason enough to reject the Treasury proposal.

On behalf of the IBAA's 6,000 members, I want to thank you for this opportunity to testify on this extremely important issue.

EXHIBIT A

Terry E. Branstad
Governor

OFFICE OF THE GOVERNOR

State Capitol
Des Moines, Iowa 50319
515 281-5211

February 22, 1994

Mr. Colin B. Robinson
Citizens National Bank
300 North Main
Post Office Box 517
Charles City, Iowa 50616-0517

Dear Mr. Robinson:

At the recent National Governors' Association Conference in Washington, D.C., the Economic Development Committee which I chair, considered a resolution which dealt with the issue of dual regulation of banks in the United States. My committee, and the National Governors' Association, reaffirmed our strong support for the continuation of the dual banking system by adopting a resolution which contained the following points.

- Preservation of the dual banking system. Federal legislation should not preempt, limit, or interfere with the rights of states to regulate state-chartered banks. The charterer of national banks cannot be given oversight of state-chartered institutions.

- Preservation of bank choice of a federal regulator. Any legislation should allow for banks to make a choice as to which federal regulator is in their best interest.

- Preservation of a broad supervisory and regulatory role for the Federal Reserve. A meaningful supervisory and regulatory role is critical for the Federal Reserve to carry out its responsibilities for the stability of the financial system.

I believe the availability of financial services is especially critical to state economies. States must have the ability to work with banks to promote economic development, community reinvestment, and credit availability. There is no question that state chartered banks offer an effective partnership for state policymakers.

I am pleased to report that this resolution passed the Economic Development Committee and was ratified by the National Governors' Association.

Sincerely,

Terry E. Branstad

Terry E. Branstad
Governor

TEB/ps

PREPARED STATEMENT OF DAVID F. HOLLAND

ON BEHALF OF

THE SAVINGS & COMMUNITY BANKERS OF AMERICA

Mr. Chairman and Members of the Committee, my name is David Holland, Chairman and CEO of Boston Federal Savings Bank, a $500 million Federal savings bank overseen by the Office of Thrift Supervision. I am pleased to be here today in my capacity as Chairman of Savings & Community Bankers of America representing some 1,925 savings institutions of diverse charter types and organizational structures.

Savings Institutions and Regulation

Savings institutions represented by SCBA include a diverse range of charter types and ownership forms. Federal and State regulators oversee both stock and mutual institutions along with new forms of incorporation such as mutual holding companies.

Savings institutions are regulated by a wide range of regulatory agencies. The Office of Thrift Supervision oversees both Federal and State savings associations. The Federal Deposit Insurance Corporation oversees State-chartered savings banks. The OTS supervises most thrift holding companies and the Federal Reserve is the regulator of a small number of bank holding companies operating thrift institutions. As with other depositories, savings institutions involved in insurance products are examined by State insurance regulators and those with securities products face review by the SEC, CFTC, and self-regulatory organizations such as NASD.

Overall Position on Regulatory Consolidation

The current regulatory structure does create costs and inefficiencies for community based financial institutions. Indeed, regulations sometimes go far beyond what Congress desired. Nevertheless in reviewing proposed changes, the Congress must be aware that most of the regulatory burden is grounded in the law, not in the independent actions of regulators. The variety of laws and structures create conflicts that regulators are asked to administer and resolve.

Modern banking regulatory structure began in 1863 with the creation of the Office of the Comptroller of the Currency as a bureau of the Treasury and has continued right through to 1993 with the inception of the Office of Federal Housing Enterprise Oversight within the Department of Housing and Urban Development.

Because of the underlying law, regulatory jurisdiction is distributed among agencies and often fragmented where multiple responsibilities exist. For example, the Federal Reserve Board is vested with bank supervision along with monetary policy; the FDIC has insurance authority and State bank supervision. Even between two unrelated statutes one may find delicate tensions created that make regulatory enforcement and industry compliance very difficult. The Community Reinvestment Act's call for meeting community credit needs must be balanced with the Federal Deposit Insurance Act and other statutory demands for the maintenance of safety and soundness. Layer upon layer of controls and regulatory structures have been superimposed, producing often conflicting goals for regulators to administer.

Heading into the next century, a fundamental review of the underlying statutory base may be far more important than reorganization of agencies. The United States banking system must have a framework of law and regulation that supports the needs of communities and customers; one that reflects a strong industry, not one in crisis. The Congress has provided authority to deal with and prevent such events. Now, the law must be consistent with the needs of a banking business that confronts new and more potent forms of competitors—foreign and domestic, many of whom are unregulated or less regulated—in a far broader economic and geographic environment than that for which the current system was designed.

As to regulatory costs imposed on community-based savings institutions, which are typically smaller depositories, the agencies and the GAO have documented the reporting, recordkeeping, and accounting costs that are involved. I would add that there is also a significant intangible cost in the time senior management must dedicate to regulatory matters that may take away from business development activities that would enhance profit and protect the insurance funds. No evidence need be provided here of regulatory burden beyond the fact that in the last year of the Bush Administration and the first year of the Clinton Administration, the OCC and OTS have undertaken regulatory burden relief initiatives that recognize the need for reducing costs for consumers and the disadvantage created by regulation in the face of growing competition from unregulated financial service providers.

History of Regulatory Restructuring Proposals

Rationalization of the complex regulatory structure created by agencies at the Federal and State levels involved in enforcing a wide array of statutory regimes has been a goal of the Congress and the executive branch for some time. Since the 1930's, many reviews of regulatory structure have been conducted.

In 1949, the Hoover Commission suggested that the OCC should be in an independent body like the Federal Reserve and moved outside of Treasury.

In 1961, the Commission on Money and Credit proposed that OCC and FDIC functions be transferred to the Federal Reserve.

In 1971, the Hunt Commission proposed two agencies to administer regulation of national and State banks and a Federal guarantee administrator to supervise the various insurance funds.

In 1975, the FINE Study by the House Banking Committee proposed a new "super agency" of the FDIC, Federal Reserve, OCC, Federal Home Loan Bank Board, and the National Credit Union Administration, which would oversee all Federal and State-chartered institutions.

In 1984, Vice President Bush's Task Group on Regulation of Financial Services produced a document entitled *Blueprint for Reform* which proposed reducing three regulators to two. Recommended reforms included eliminating the FDIC's supervisory role and creating a Federal Banking Agency in the OCC for national banks and employing the Federal Reserve for State-chartered institutions and large bank holding companies. State-chartered bank oversight would be reduced and generally entrusted to a State once its Administration was certified by Federal regulators; Federal intervention could come from reserved authority in the insurance funds.

Finally, the 1991 Treasury study, *Modernizing the Financial System* drew heavily on the Bush Task Group, recommending a single Federal regulator for each banking organization. The Federal Reserve would regulate all State banking institutions and a new agency under Treasury would regulate all national bank and State and Federal thrift institutions. The FDIC would act solely as an insurer.

Much of the background analysis in these studies remain valid and I would highlight just two illustrations of the burden of regulatory structure has placed on institutions. The 1984 study *Blueprint for Reform* noted that in 1980–1982, the FDIC and Federal Reserve reviewed 3,652 applications from State-chartered institutions to open branches, almost all of which were reviewed by State regulators; only 11 were denied, or about .3 percent. This was clearly an unnecessary waste of resources on a procedure that does not affect safety and soundness and was adequately reviewed by the States.

Next, the study noted that a State-chartered, nonmember bank with a one bank holding company is routinely examined by three regulators—the FDIC for its State bank, the Federal Reserve for its holding company and a State regulator for the bank. Clearly, duplication of reporting and excessive concern with State regulation are evidenced here and could be eliminated as part of sensible regulatory reforms. It may be noted that the new Treasury Department would attempt to address this issue by certifying State examinations in certain instances.

Current Proposals

SCBA finds the various proposals such as S. 1633, H.R. 1214, and the new Administration document along with the Federal Reserve Board's views to be valuable starting points for discussion.

I must tell you, however, that it is SCBA's position that a number of questions need to be addressed for us to endorse any particular initiative.

For example, some groups have attributed greater substantive content to the current debate over a single versus multiple regulatory approach and that has permitted them to reach a decision. To SCBA this debate appears to remain ill defined and to beg important questions over the framework of regulation and the resulting regulatory and supervisory processes as applied, once some version of reform is adopted. The new Treasury proposal does begin to focus on this issue in Section 301.

The idea of moving to a single versus multiple regulator format, if presented in isolation, would not have the support of SCBA because, standing alone as an administrative merger, the measure does not provide enough substantive relief to merit disruption of the current system. This is not because we perceive an inherent threat to the dual banking system or because of some other threat to our industry. Simply put, this limited revision does not appear to provide enough real value to merit such changes. If that were the only choice—putting four or five regulators into one office building—then we would suggest that first improvements be made in the law and in regulation within the existing framework.

Overall Concept

SCBA supports Federal regulatory restructuring that addresses the basic issues of differing legal regimes, accounting, examination and enforcement approaches, high overhead costs and produces a streamlined, competent and efficient regulatory structure and staff.

A certain amount of inefficiency and duplication of overhead costs in the current system may be remedied by administrative reforms. For a comprehensive reorganization, other goals must be set forth to merit the high transition costs. Frequently, announced cost savings prove elusive so that the long-term creation of a professional, mature, and balanced organization and production of a cost efficient supervisory and examination regime is critical. We believe that this can be incorporated into proposals such as S. 1633 or the Administration bill.

Clearly unified rulemaking and supervision would add value for multi-charter holding companies and would eliminate certain conflicting regulatory interpretations for institutions engaging in several lines of business.

SCBA feels strongly that to support a new structure, the unitary thrift holding company charter must be preserved. This charter form has proved its value over time and permitted savings institutions to provide a wide range of financial services to people and communities.

SCBA can support regulatory restructuring that does not diminish the dual banking system. Banking agency restructuring should be an opportunity to enhance the strength and utilization of the flexibility and resources of State-chartering authorities. SCBA feels strongly that banking charter options should remain available at the Federal and State levels and a new regulatory structure should not diminish the competitive vitality of depository institutions by unduly limiting their range of charter choices. The Administration bill attempts to move down this road by certifying State examinations and State review of compliance with Federal consumer laws by State banks.

Finally, *SCBA feels that an independent regulatory structure, removed as much as possible from short-term political considerations is best for the financial system that is the underpinning of our market economy.* Current proposals do not appear to us to maintain this independence as much as would be desirable.

Impetus for Action—The OTS and Premium Disparity

For savings institutions, two central issues press for regulatory restructuring—the status of the OTS and housing GSE's and the burden of premium disparity on SAIF-insured institutions.

OTS. First, it is clear that the Office of Thrift Supervision faces funding challenges. As OTS has indicated, while it has problems, the agency remains viable at this time and indeed, appears to have as much as $100 million in reserve.

SCBA welcomes a review of an OTS and OCC merger that meets with long-term goals set forth above. However, in line with our earlier views, a consolidation limited to these two agencies still must be undertaken with consideration of more than just an "administrative merger." Attention must be paid to consolidation of legal, accounting, and examination functions, as well as differential regulation under such a new structure where different charter types coexist within the same regulatory jurisdiction. The OCC has not had experience with this charter form, given its intense focus on the national bank charter.

Further, cost structures relating to personnel, examination and other charges must be addressed to ensure that institutions are not adversely affected. SCBA recommends that in such a merger, as proposed in prior studies, all Federal savings institutions and federally-regulated holding companies remain or move with the primary Federal savings institution regulator they have today.

A merger with the OCC could have many beneficial aspects. Congress must make a clear choice whether such a merger should be administrative only, or a true functional merger that entails clear decisions up front on future rulemaking, treatment of current rules and regulations, examination, education, orientation programs, and the like.

SCBA notes that the current discussions have focused on a "broad" consolidation of all banking agencies or a "narrow" OCC-OTS merger. Another area that must be addressed is that of housing finance regulation. The Federal Home Loan Bank System and the new Office of Federal Housing Enterprise Oversight at HUD are again two overseers of Federal Government sponsored enterprises that should be analyzed for regulatory burden and restructuring. SCBA is aware that HUD, Treasury, and the Bank System are undertaking a review at this time and these recommendations soon should be made available for public comment and congressional consideration.

SCBA believes that this aspect of regulatory consolidation for the crucial consumer market segment of mortgage finance should be coordinated with the review of depository institution regulation.

Premium Disparity. Far more significant in dollar terms than any savings from regulatory restructuring is a coming premium disparity between BIF and SAIF insured institutions. The Committee is familiar with this issue which was raised during the recent RTC funding legislation and in recent responses to questions for FDIC Board nominees.

SCBA would note here that this premium differential may have much more immediate consequences for our members and the FDIC insurance funds that any agency restructuring. Congress should ensure that no restructuring proposal adversely impacts or delays consideration of this critical issue.

At present, both BIF and SAIF insured institutions pay a deposit insurance premium averaging 0.25 percent of insured deposits. Absent corrective action, a significant premium differential between BIF- and SAIF-insured firms will emerge sometime in 1996.

First, BIF and SAIF funds are required to be recapitalized at a ratio of reserves to deposits of 1.25 percent. BIF is now projected to meet that target ratio by 1996. SAIF would not be recapitalized for another 9 years. This would create a premium differential of some 6 basis points. (SAIF has fallen behind because for 3 years all premiums paid into SAIF were diverted to the RTC to cover resolution costs for failed institutions.)

Second, SAIF institutions are saddled with a diversion of funds from the SAIF fund until the year 2019 to cover the debt service for bonds of the 1987 Financing Corporation (FICO), amounting to a 11 basis point tax. The proceeds of these bonds also were devoted to problem case dispositions. Continuing this burden during the time when SAIF is not fully recapitalized could create a total premium differential of some 17 basis points. This undermines competitive capacity and the strength of FDIC funds.

The combined effects of capitalization schedules and FICO will result in a differential between BIF and SAIF premiums of 17 basis points from 1996 to 2003, and 11 basis points from 2003 to 2019. Computed as an equivalent tax, the premium differential would have the same effect as a differential tax levy of an added 21 percent on earnings at SAIF-insured institutions until 2003, and 14 percent thereafter.

The differential "tax" will sharply lower return on equity at SAIF-insured institutions and will impact adversely the ability to raise capital which the industry has been successfully undertaking over the past 3 years. Further, there will be an impact on the ability to service community credit demands. Community-based lending institutions that are providing valuable services for housing and other consumer needs may face indefinite stagnation.

Alternatives must be considered to ameliorate the impact of the FICO obligation on the premium disparity. Among items that should be considered are dedication of unexpended RTC funds to be used to reduce FICO, direct appropriation of funds, merger of the deposit insurance funds, and other concepts to reduce the premium differential.

S. 1633

Senators Riegle and D'Amato have a detailed legislative proposal for consideration. SCBA believes that this bill could provide the vehicle necessary to advance regulatory restructuring along with the new Administration proposal. SCBA believes that the key now is to provide additional substance to the proposal and this testimony attempts to do that.

The bill's call for a Federal Banking Commission basically provides for an independent regulator concept and SCBA fully supports this objective.

Role of Federal Reserve. Under this proposal, the Federal Reserve appears to retain capacity to secure information, but the FDIC and Board would both lose their current supervisory roles. SCBA does feel that it would be wise to permit the Federal Reserve to retain supervision over large bank holding companies that are involved in the payments system in a significant way and which are active players in the monetary process as primary dealers, as they are primary transmission channels for monetary policy.

Details of Commission. SCBA believes that the Banking Commission's mission statement and operational limits should be established clearly by statute. Further, membership on the Board to include someone experienced with State regulation would be useful and there should be greater specificity as to the exact roles of the FDIC and Federal Reserve should be provided.

FDIC Role. Next, the role of FDIC backup enforcement authority requires more clarification. This authority should be stated with greater specificity to avoid any ambiguity in the role in supervision for the FDIC and any opportunity for the type of "turf battles" that S. 1633 intends to remedy.

Dual Banking System. In the area of the dual banking system, SCBA urges the Committee to look to explicit enhancements in the role of State-chartering agencies while retaining clear Federal oversight such as where the Government must protect the insurance funds. The current debate over transfer of all authority to a single regulator or to a separate regulator just for State institutions at the Federal level avoids a more fundamental point—the role of State-chartering authorities under any system. SCBA believes the State role should be enhanced.

SCBA would support under any regulatory configuration, a stronger Federal endorsement of the role for State-chartering institutions. Deposit insurance concerns should not impede full utilization of State supervisory resources and avoidance of costly and duplicative Federal intervention. Some ideas for the Committee to consider would be to clarify that examinations by States that operate sound supervisory systems would be acceptable for Federal purposes and to clarify that for routine banking functions of a general business nature and other primarily operational activities State determinations would be final. The Administration proposal addresses the former concept but not the latter.

Further, the limitations in the Federal Deposit Insurance Corporation Improvement Act on State activities should be modified and implemented under a more coherent approach. At present, State banks may engage in activities permitted to national banks and may engage in activities not permitted to national banks where the FDIC determines the activity does not pose a risk to the insurance system. This appears to be working well. The Committee might wish to strengthen the State role while protecting the insurance fund by providing a third alternative—State banks may engage in activities that the FDIC does not endorse so long as they are undertaken in a separately capitalized subsidiary and do not employ insured deposits for funding. This would permit innovation at the State level, enhanced community services and protect the insurance funds. Congress should recall that existing anti-tying restrictions apply, but the depository should be able to access the marketing synergies that provide economic benefits to a banking structure.

Independence. Though not in S. 1633, SCBA has concerns with the independence of the FBC under the Administration proposal. The FBC would be required to submit regulations, congressional testimony, and legislative proposals to the Office of Management and Budget for review. This approach is highly inconsistent with the goal of regulatory independence and has no place in any proposal. SCBA supports creation of a fully independent agency along the lines of the FDIC or SEC. SCBA likewise shares the concerns expressed yesterday by Chairman Riegle and Senator D'Amato over any subordination of FBC litigation authority to the Department of Justice along the lines of the Administration approach.

Funding. How the Federal Banking Commission will be funded obviously is of interest both in absolute terms of costs as well as the impact on different charter types and on the dual banking system. Here SCBA recommends clarification of the funding mechanism and suggests that a possible route is to have the FDIC pay for the operation of the new supervisory system out of the premium stream as is currently done for FDIC operations. This operating budget would be subject to regular congressional review.

Personnel. A very important item is personnel and retention of professional expertise. SCBA members value a well-trained, stable, and professional regulatory staff. Expertise built up over years of dealing with different charter types should not be lost in a restructuring. The retention and addition of personnel familiar with different charter types needs to be part of overall planning in any restructuring.

Single versus Multiple Regulators. SCBA reserves judgment for now on a single versus dual regulator for the reasons we stated. If our concerns and the opportunities we see are addressed, then SCBA can move to support legislation. Clearly, the Committee should look to refine the proposal to clarify its impact on the dual banking system and to increase the amount of information on "post consolidation" operations.

SCBA is interested in a Federal Banking Commission, but believes that firm support can come only with a clearer picture of such a regulator's independence, its impact on the dual banking system and the ability to establish legitimate internal working mechanisms for appeals processes that avoid an all-or-nothing situation for supervised institutions.

SCBA Formal Position

SCBA supports further consideration and appropriate action on regulatory consolidation.

The Federal Banking Commission has merit; the entire concept should be clarified to insure that key issues are addressed. Key among these are:

(1) regulatory independence;

(2) maintenance of existing regulations for a set transition period;

(3) unitary thrift holding company remaining a distinct regulated entity as well as retention other charter forms and alternatives;

(4) maintaining and enhancing personnel resources to oversee differing charter types;

(5) ability for appeals such as an administrative law judge system;

(6) costs are fully explained; and,

(7) State banking system impact minimized and State regulation enhanced through clearer recognition of State exams and operational determinations.

If change from the current system is to be more than a mere rearranging of "boxes" on an organization chart and this must be the case to merit such restructuring and uncertainty, a strong and clear description of the new system is imperative.

SCBA remains very supportive of regulatory restructuring. SCBA believes that this is an opportunity not only to reduce costs and streamline Administration, but as well an opportunity that can truly benefit consumers. SCBA looks forward to working with the Committee and the Administration and agency to provide a strong framework for the future. We cannot simply "leave the details up to a new agency." The financial industry needs answers on directions and goals and can then become advocates of the initiatives you have begun in S. 1633.

BANKING INDUSTRY REGULATORY CONSOLIDATION

FRIDAY, MARCH 4, 1994

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met in room 538, of the Dirksen Senate Office Building at 10:10 a.m., Senator Donald W. Riegle, Jr. (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The Committee will come to order. Let me welcome all those in attendance this morning.

This morning we are pleased to welcome Mr. Charles Bowsher, the Comptroller General of the United States, who's appeared here many times before, and his professional staff.

Today, we'll be holding our fourth hearing this week on the subject of regulatory consolidation within our banking system.

We're pleased today to have the independent assessment on consolidation by the GAO.

Mr. Bowsher, I particularly appreciate the fact that you are supportive of our efforts to consolidate the bank regulatory agencies. In your testimony you state that the GAO believes "a logical step would be to combine OTS, OCC, and FDIC supervisory responsibilities for State-chartered banks that are not members of the Federal Reserve system."

I also understand that time has not allowed you to review the Federal Reserve Bank supervisory role, as it relates to systemic risk and monetary policy, and therefore you are not able to address this important issue today. Next week, we will be looking deeper into that issue.

Yesterday, at our hearing, Senator D'Amato and I agreed that "independence" is fundamental to any consolidation proposal. We have also agreed to continue to work together on a bipartisan proposal.

Over the past 3 days, we have heard from the Administration, the bank regulators, and a number of association groups.

This morning, in addition to Comptroller Bowsher, it's also a pleasure for the Committee to welcome Charlene Drew Jarvis of the District of Columbia, Chairwoman of the D.C. Committee on Economic Development and who is knowledgeable with respect to many of the banking issues that affect our local DC community.

Mr. Thomas Schatz, who is the president of Citizens Against Government Waste. Dr. Wolfgang Reinicke of the Brookings Insti-

tution. Mr. James Barth, Professor of Finance at Auburn University, whom we've heard from before. And finally, Mr. Dan Brumbaugh, an economist who is well-known to the Committee and has been very helpful to us on other occasions.

We'll make your full statement a part of the record, Mr. Bowsher, and we look forward to your testimony.

STATEMENT OF CHARLES A. BOWSHER, COMPTROLLER GENERAL, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC, ACCOMPANIED BY: STEPHEN C. SWAIM, ASSISTANT DIRECTOR, FINANCIAL INSTITUTIONS AND MARKETS ISSUES; JAMES L. BOTHWELL, DIRECTOR, FINANCIAL INSTITUTIONS AND MARKETS ISSUES; AND ROBERT W. GRAMLING, DIRECTOR, CORPORATE FINANCIAL AUDITS

Mr. BOWSHER. Thank you very much, Mr. Chairman.

I'm going to read just the first page and a half and then do a summary. I appreciate being invited to come to testify. I'm accompanied today by Bob Gramling on the left here, who has done many of the audits of the banks and thrifts and the various financial institutions over the last 5 years. Jim Bothwell on my right, heads up all our work in the financial institutions area. Steve Swaim, over there, is the one who supervised the work that is the focus of this testimony, and has done many of our important jobs in the financial institutions area.

I'm pleased to be here today to discuss legislation to consolidate the activities of the four Federal agencies responsible for the regulation and supervision of more than 13,000 banks and thrifts. These institutions, together with their holding companies and the 600 U.S. branches and agencies of foreign banks that would also be affected, hold more than $5.5 trillion in assets.

I welcome the Committee's interest in simplifying the regulatory structure, and I would like to commend you for taking on this longstanding and very difficult issue.

Over a year ago, as part of the testimony that covered a number of banking and thrift issues, I suggested that there were opportunities along these lines that should be considered.

Several proposals have been made recently for consolidating the regulatory activities of the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Reserve, and the FDIC. Some of these proposals would place all these activities in a single new Federal Banking Commission, while others would retain more than one regulator. The relative strengths and weaknesses of each major approach need to be carefully debated and I hope that my remarks will be helpful in that regard.

We support the objective of reducing the current number of Federal regulators. However, until the questions about the role of the Federal Reserve in bank supervision can be resolved, we think a logical step would be to combine, into one independent agency, the OTS, OCC, and FDIC's supervisory responsibilities for State-chartered banks that are not members of the Federal Reserve system.

Also, Mr. Chairman, as you remember last year, when we discussed our report, "Improvements Needed In Examination Quality and Regulatory Structure," here before this Committee, we pointed out some of the problems we had noted in our work over the last

few years involving examinations. One, there was a lot of duplication. Two, there was overlap in how the work was done, and many times conflicting advice was given to the various institutions and they certainly worried about that.

I think there was just the general feeling that we had so many different groups coming in auditing these various institutions that something needed to be done. So, therefore, we do really strongly recommend that something move forward at this time.

We've also said, over time, that we think improved regulatory practices should accompany any restructuring and I would, again, like to say that I think it's awfully important that the internal controls in the systems of all these institutions be reviewed very carefully as part of any new structure. That would also include looking at how the controls and procedures are on derivatives, which is becoming more and more an important part of the banking world. I think the role of management, the Board of Directors, the CPA firms, all of these, should be looked at very carefully, and I think that the reliance on the various work should be coordinated as much as possible.

As you point out, Mr. Chairman, we have not had the role or the time to look at some of these roles of the central bank.

I know Chairman Greenspan has made a very important point about what he feels is important with the issue at hand. We also are aware that he has made a significant issue on the handling of these big crises. We have worked with the Federal Reserve on most of the big crises of the last 25 years. I think, on balance, they've done an excellent job in handling many of these. It's just somewhat uncertain how much their regulatory role helps them do that.

But there's no question they do have a major role here as the lender of last resort and in handling some of these big crises. And I think that should be given quite a bit of consideration.

There is also the role of the FDIC. We are a strong believer that the FDIC should have an independent role, although they don't have to, I don't believe, do all the reviews that they do today. And therefore, we do support the consolidation of their supervisory function into this new Commission. I think it's important that they have the ability to look at any trouble situations at any time when the insurance fund appears to them to be at risk.

So, Mr. Chairman, the last thing I'd like to say is, I think it is important to move forward at this time. I think there are some other big issues down the road. Derivatives is a very big issue down the road that has to be looked at. And one of the problems there is that neither the banking regulators nor the securities regulator, the SEC, have a total purview over how the whole system is working. Derivatives are being done by all different groups including the insurance companies and overseas institutions.

I think, at some point, Congress will have to come back and look at the overall regulatory structure of all the financial institutions, but we would recommend, at this time, that as much consolidation as possible could be worked out here in the banking area.

That would conclude my prepared remarks. I'll be happy to answer any questions.

The CHAIRMAN. Thank you very much. I appreciate your testimony today.

I have only a few questions because the value of your analysis is contained in the report you've given us. But let me ask you how important is it, in your view, that we move forward promptly with consolidation legislation?

Mr. BOWSHER. I think it's very important, because we have a lot of duplication out there, and as we saw in these crises in the past, lots of times, mixed signals were given to some of the Boards of Directors. Some of these people had to make the tough decisions on what to do with these institutions. I think we ought to be beyond that.

I think when you look at some of the other countries, you can see that they have a much more consolidated view. Some of them have a role with the central bank, some don't, but they all have a more consolidated approach than what we do. And I think this highly fragmented approach that we've had is one of the things that got us into trouble here in the last 5 years.

The CHAIRMAN. Do you think it would be worth proceeding to merge the OCC, the OTS, and the FDIC into an independent commission, even if the differences between the Federal Reserve and the Treasury, regarding other areas of consolidation, have not yet been worked out?

Mr. BOWSHER. Yes, I do. I think that would be worthwhile.

Also, I think it's an important point to recognize that these are big mergers, these are not going to be easy to achieve. There's going to be a lot of tough work in bringing these different cultures and different systems together. So, I think if you could accomplish that much, it would be a major step forward.

The CHAIRMAN. One other thing, I would like to share my concern over the derivatives area. We talked about this before. I think that the lack of one regulator being in charge is very troubling.

The other day, we had all four bank regulators seated at the table where you are now. I asked the question: Who has the responsibility over the derivatives issue? Well, it turns out nobody really has; everybody and nobody.

Mr. BOWSHER. Everybody has a piece of it.

The CHAIRMAN. Everybody has some and nobody has it all, and nobody has a clear picture, as far as I can judge, as to what the overall situation is or what the risks, even the systemic risks, may be. To me, that falls into a more subtle category of what we're trying to accomplish with intelligent and well-engineered consolidation of bank regulatory functions.

In other words, the obvious problems you get when you have four regulators, is overlap, duplication, and opposing standards. This can lead to as many as three or even four regulators examining the same institution at the same time. We've actually had situations like that described to us. That's an obvious inefficiency and common sense says we ought to try to eliminate it.

What's harder to see are the things that fall through the cracks and that you don't see until a huge problem has happened.

When you've got a fragmented system and a situation where nobody is really in charge, you can have this problem where bits and pieces are scattered to different places. But nobody ever has the authority to aggregate it all and focus directly on the problem. It's,

in a sense, analogous to the case you've been making for a long time on internal controls within an institution.

Mr. BOWSHER. That's right.

The CHAIRMAN. And you've argued forcefully for a series of internal controls that allow that kind of summation and monitoring ability to occur within an institution.

That principle, it seems to me, applies the same way to derivatives. That is, if you do not have the responsibility clearly defined and it's fractured and split up all over, you have no way of knowing what's falling between the cracks.

You've warned us about derivatives for a long time and I take the warnings seriously. But I have to say that over a year and a half ago, on June 5, 1992, I asked the GAO to do a report on derivatives because I figured that somebody has got to do the bloodhound work on this, as complicated and exotic as it may be, in terms of its analysis. We've not yet gotten that report, may I ask what's taking so long?

Mr. BOWSHER. Jim Bothwell here is in charge of this work. It has taken longer than we would have liked.

One factor is our decision to conduct a survey that took several months. That is one of the main reasons. But also pulling the work together and writing it has proven to be a more difficult job. We hope to be ready right after the recess some time with this product, and I'll let Jim add to what my comments were here.

But I share your concern, especially about getting this report to the Congress.

The CHAIRMAN. Let me ask you this first, I think we need to come to an understanding as to when the Congress will get this report, say, within 60 days. But more than that, once we get it, we need recommendations. In other words, this is one area where I think you folks, perhaps better than anybody else, are in a position to really make some important policy recommendations and help guide us.

I am looking for the GAO to come and give us some ideas as to how we get a proper fence around these activities. Is 60 days a workable time frame, and will we be given specific recommendations?

Mr. BOWSHER. Certainly 60 to 90 days is a workable time frame, and we definitely will have recommendations.

The CHAIRMAN. When they're ready, will you come back and lay these out for us?

Mr. BOWSHER. I sure will, yes.

The CHAIRMAN. I'm going to put anything else we have scheduled aside to accommodate that hearing, because I think this issue is of a single importance. I appreciate that commitment.

Mr. Bothwell.

Mr. BOTHWELL. Mr. Chairman, I just want to assure you that we have a very large and capable team working on derivatives. We're doing everything in our power to get this work done as quickly as we can.

We've already completed all our audit work, as Mr. Bowsher said. We ran into a great deal of time delay in terms of getting our survey accomplished. We have no right of access to some of these big derivatives dealers, so we had to rely on an independent ac-

counting firm to help us do this survey. They had to compile all the data. That put us back quite a few months. Nevertheless, I think that that delay is going to be worth it in terms of the information that we're going to be coming up with. It's information that really doesn't exist now in terms of how large this market is, who the dealers are, and what the interrelations among the derivatives dealers are.

Another aspect of it is that this is not only a very complex subject, where new products are essentially being invented almost overnight, but also the regulators are now taking some very positive actions. So we want to make sure that we're right up to date in terms of where everybody is on this issue in our report, so we can be as accurate and as comprehensive as we can be.

In addition, with regard to your concern, there's been a number of studies done on derivatives. It seems like it's a very big growth industry itself, this business of doing studies on derivatives and conferences on derivatives. But we are planning to do exactly what you hoped that we would do. We want to be able to tell the Congress what the Congress needs to do in this area. There's been a lot of different studies done about the size of the market, the types of products, and what the regulators are doing, but I'm sure that you and other Members of the Committee are very much interested in what it is that Congress needs to do. And that is exactly what we're going to be focusing on.

The CHAIRMAN. May I ask, is there a way for you to express the dollar volume of derivative activity that's out there now, or the number of transactions that would fall into that category that, in effect, create an asset class or an exposure class of some size?

Mr. BOTHWELL. Yes, sir. The number you want really depends upon what measure you're looking for. If you're looking for a measure of volume in this market, the best data available tell you that it's around $12 trillion in terms of notional or principal amount. But that is not a good measure of the amount at risk for these institutions that are involved with this market. That amount is somewhere in the neighborhood of 1 to 2 percent of that notional or principal amount.

The CHAIRMAN. One to 2 percent of the $12 trillion. That assumes that if you have a chain reaction, that starts from whatever source, all of a sudden, you get an instability.

Do we know enough about this to understand that if people have to start squaring accounts that, in effect, the bottom line of what's at risk in losses would only be 1 to 2 percent of the $12 trillion?

Mr. BOTHWELL. Our best information is that it's about the amount that you'd have in terms of your exposure to different types of counterparties in total. So on a net basis——

The CHAIRMAN. Is there not risk in this area, as we've seen in other areas, where if a given institution burns through its capital, it can't reconcile its books and its payments? In other words, does what you've just said assume that everybody can clear at the end of the day so that all the accounts match out?

Mr. BOTHWELL. Yes, sir.

The CHAIRMAN. If you don't have that, what's the degree of exposure if somebody is left holding the bag and you get this rattling on through. What's the level of exposure then?

Mr. BOTHWELL. That figure is going to be higher than the 1 to 2 percent that assumes that the clearing will all take place. If there's a problem in terms of liquidity and you can't settle, then those gross exposures are going to be larger than the net.

Mr. BOWSHER. That would be a systemic problem at that point, much as you've had those kind of risks here in the past. When you get large institutions, if they can't make good, then you have a real systemic problem that could be very large and——

The CHAIRMAN. Is that one of the dangers that we have to be concerned about here?

Mr. BOWSHER. I think it is, because I think the derivatives by themselves, today, are so large it's just like Third World debt or any of the other areas that have gotten us into problems in the past.

If this area gets you into a problem, then there's no question. It could be very worrisome. If you were to just think about Jim, who was just over in Germany and, of course, they had a big industrial company there that was on the wrong side of that, you might say, and that's got all the big German banks very much worrying about their situation. In addition to this one, I think it's the 14th or 15th largest industrial company in Germany.

The CHAIRMAN. I've been reading about that. That's one of the things that adds to the concern. We've worked so hard in other areas of financial structure that are more traditional and long-standing, to develop certain safeguards, clearing mechanisms, backup systems, monitoring devices, and so forth. And we worked very hard to refine those things.

Sometimes discreet product types tend to fall within a vertical structure, so it's somewhat easier to measure and contain. What I'm sensing here with derivatives is that this is a business that is spun out across a broad horizontal plane. You talk about insurance companies, you talk about banks and industrial companies and other things. As a result, I think the ability for our existing system of regulatory supervision may not be designed to properly capture that kind of development.

So we may be way behind a product-type explosion which gets up to the level of approximately $12 trillion. But at the end of the day, if you've got a defective clearance mechanism where people, like this German company, have bet the wrong way, and can't settle their debts, and that starts to rattle through the financial system. Maybe even rattle through the international financial system. And it seems to me that you could get a cardiac arrest in your financial system that nobody had the foresight to anticipate and, therefore, try to prevent from happening.

To me, banking consolidation relates, in part, to this question, because the issue is: Who's responsible? I've seen too many instances where we've brought bank regulators to the table on commercial lending problems, Third World bank problems, or other things. And it was always somebody else's problem, somebody else's mistake.

But this one is in a special category of concern. So I am very interested in what you have to say and the recommendations that you have to offer. I would say to you that if anybody is stonewalling you on information that you need, I need to know

about that because we may need to go after that information in a different way. I don't want to be in a situation where we don't have the factual information available to us that we would need to make good public policy judgments. If there is a problem in that area, we need to know that.

Mr. BOTHWELL. To date, sir, we've had the ability to get the information we think we need to have and the audit work is done. We're just pulling together the report.

The CHAIRMAN. We look forward to seeing you. You'll be back within 60 to 90 days. Mr. Bowsher, we'll look forward to your making that presentation. I can tell you, there's very keen interest in this.

Thank you very much for participating today.

Mr. BOWSHER. Thank you very much, Mr. Chairman.

The CHAIRMAN. Let me excuse this panel and ask the other witnesses to come forward.

[Pause.]

The CHAIRMAN. Let me welcome you all. Thank you for your appearance here today and for the time that you've taken to prepare your testimony for us. I'm going to go in the order in which I introduced you earlier, so I'll proceed down that list, starting now.

We'll start with you, Ms. Jarvis. You are Charlene Drew Jarvis, representing the District of Columbia, and you Chair the D.C. Committee on Economic Development.

I know you've specialized in a number of banking issues that affect this local area, so we're pleased to have you, and we'll make your full statement a part of the record, and we'd like your testimony now.

STATEMENT OF CHARLENE DREW JARVIS, COUNCILMEMBER, WARD 4, WASHINGTON, DC, AND CHAIRPERSON, D.C. COMMITTEE ON ECONOMIC DEVELOPMENT

Ms. JARVIS. Thank you very much, Mr. Chairman. I'm delighted to be here to testify before you today on Senate Bill 1633, the Regulatory Consolidation Act of 1993, introduced by you and by Senator D'Amato.

I'm here today to voice my support for that legislation, the consolidation of bank supervisory functions in a Federal Banking Commission, because I believe that the ultimate result of the consolidation will be an improvement in banking services to individuals and businesses, and an increase in confidence in the efficiency and equity of our banking system, generally.

During most of my tenure as a locally elected official, I've had the privilege of serving as the Chairperson of the Committee on Economic Development, as you've mentioned. The responsibilities of this committee include oversight for the recently established Office of Banking and Financial Institutions, whose acting superintendent, Linda McGhee, is here with us today. That office charters and regulates banks operating within the District.

In addition, my committee reviews and approves mergers and acquisitions of banks and bank holding companies in the District following the local superintendent's review and recommendations.

Last, the committee assists in negotiating and monitoring banks' community development requirements pursuant to D.C. Law 6–107.

I'd like to enter into the record some of the experiences I've had as a local official of a city-State working with Federal bank regulatory systems. I believe these examples may aid the Committee in understanding how the current regulatory system might be streamlined to better meet the needs of consumers, businesspersons, and banks alike.

I understand that certain witnesses have a concern about the bill's impact on the dual banking system. While I appreciate those views, I'm testifying from the vantage point of a legislator in a jurisdiction with almost all federally-chartered banks.

My experience during the drafting of the Regional Interstate Banking Compact is as follows:

Until 1984, my committee's responsibility for banking was almost vestigial. In that year, the District, however, decided to exercise its congressionally conveyed authority, under the Douglas Amendment to the Bank Holding Company Act, to authorize the District to participate in interstate bank mergers.

This was the first time that we interacted in any meaningful way with Federal regulators, as we sought to become part of the Southeast Compact of 11 States that would allow reciprocal interstate banking.

I must mention at the outset that individuals at the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the then Federal Home Loan Bank Board, were always helpful, always courteous in assisting us in crafting this significant legislation. Thus, I limit my critique today to the current regulatory framework, rather than to any individual or individuals in this regulatory system.

It was important to our committee that community development commitments be part of any merger application into the District. We believed that these commitments would help ensure that out-of-State bank holding companies would address local needs.

It became immediately clear to me, however, that there would be some confusion and overlap in enforcement between several of the Federal bank regulators and between the Federal regulators and the District's Office of Banking, as we finalized the community development portion of our legislation.

Such confusion could occur because these development requirements were more stringent than Federal Community Reinvestment Act regulations, and because at least two Federal regulators would be responsible for reviewing the validity and enforcement of these commitments.

The Comptroller would have a say because, of course, nearly all banks are federally-chartered in the District. Thus, the Comptroller's compliance examiners and auditors would review the commitments of the holding company's bank subsidiary. In addition, the Federal Reserve would have some level of jurisdiction because of its responsibility for the holding company structure.

I don't believe that the respective Federal regulatory roles were ever clearly established as to the District's community development requirements.

As I recall, implementing our current banking laws became an exercise in fortitude and certainly a lesson in patience for members of the Committee on Economic Development. Letters and opinions went back and forth between Federal agencies and my committee, and we finally arrived at some understanding about how much authority we had with regard to national bank community reinvestment commitments and about which regulators would be reviewing the community development requirements. I believe that this process would have been less elusive if completed within the structure of the proposed Federal Banking Commission.

Next, let me go to my experience during the mergers and acquisitions process.

My experience with the mergers and acquisitions process in the District is that my committee must comprehend a myriad of Federal and local standards prior to any approval by our legislature of merger applications.

For example, a D.C. merger applicant with a holding company must apply to the Federal Reserve and speak to issues of the parent company's stock ownership, and the overall quality of capital and assets of the parent.

The bank subsidiary, however, must apply to the Comptroller of the Currency and speak to issues of the subsidiary's health, the branching laws, operations of the bank, and convenience to the community. And of course, the Justice Department and Securities and Exchange Commission have an ancillary role because of issues of antitrust and publicly held stock, respectively.

Having gone through some 11 mergers and acquisitions in the District, I now believe that the current decentralization of regulatory responsibilities can, in fact, hinder a regulator's ability to accurately view a merger transaction or to understand its full impact.

Additionally, a recent District merger applicant applied, consecutively, to Maryland State regulators, Federal Reserve regulators, the District regulators, and finally, to the Comptroller of the Currency.

I take the position that these varied applications were, in effect, one related transaction that should have been reviewed by a single regulator. I believe that we are at a disadvantage when each regulator reviews an application according to his or her own regulations, precedent, and standards.

The disadvantage occurs because each regulator sees only part of the merger picture. I'd add that the current regulatory structure invites a degree of forum shopping. This simply means that banks attempt to merger under statutes and regulations that are more beneficial to them. That also means that, with a good attorney, you can find out which regulator has historically been willing to grant the kind of merger that you seek.

This situation would be effectively cured under the proposed Federal Banking Commission because standards would be uniform.

Now, my experience with failed District banks. As this distinguished Committee is aware, several banks located in the District have failed within the last few years. In the wake of the failures, I learned that the FDIC's supervisory powers, in cases of weak or failing banks, were quite omnipotent and overrode other laws and regulations.

Bank customers and business persons contacted our office and stated that they did not have an understanding of the FDIC's role, and that the FDIC seemed not to be concerned with any community commitments that had been, heretofore, hammered out by the District.

Here, again, there would have been a benefit to the community if the FDIC retained its insurance role and if the supervisory standards were the duty of a single regulatory body.

I'm cognizant that the FDIC was dealing with serious safety and soundness issues, but this begs the next question. Which is, why weren't the banks' capital and managerial problems dealt with much sooner? And who is at the wheel of the Federal regulatory ship?

I believe that a properly constructed consolidation bill would lead to a more efficient warning system to spot banks that are, in fact, in financial trouble. I'd also like to mention that the plethora of failed banks nationwide, during the last several years, led to overregulation of banks by Federal regulators, and within a period of less than 10 years, Federal regulation swung wildly between deregulation and overregulation of financial institutions.

This erratic regulatory structure does not aid in creating a stable and growing economy. I'd hope that by streamlining the regulatory structure, the standards for banks would be consistent and not capricious.

Finally, my experience with local business and homeowner complaints. As an urban area with a large minority population, the District, like many similar cities, has problems with residents receiving equal access to capital from financial institutions. Unfortunately, this problem is compounded by the lack of a clear and cohesive response from Federal regulators.

During a recent hearing, which I held at Union Temple Baptist Church in the southeast quadrant of our city, where many of the germane Federal regulators were, in fact, present, my committee could not get a unified response on a number of issues.

For example, who has the ultimate authority over individual complaints of mortgage discrimination based upon race or other statutorily-protected classes?

In fact, the best answers at that hearing came from HUD, rather than any of the bank regulators.

Two, has the hiring of minority appraisers been statutorily addressed with regard to the Resolution Trust Corporation in the FIRREA law?

Three, why are certain banks receiving excellent or satisfactory CRA grades when their depositors feel they don't adequately serve the community?

Under the proposed Federal Banking Commission, the community would have some guidance as to where banking complaints could be quickly and equitably handled, because one agency would be responsible and accountable in this area.

In summary, Mr. Chairman, my experiences as a local legislator have shown me that our current financial regulatory system is in need of more consolidation and less duplication. And the Riegle-D'Amato bill, if enacted, will start us down a streamlined regulatory path.

Mr. Chairman, this concludes my formal testimony. I want to thank you and the Committee for permitting me to testify today, and I look forward to answering your questions.

The CHAIRMAN. Thank you very much. It's a very fine presentation and very helpful to us.

Mr. Schatz, you are president of Citizens Against Government Waste. We'd like to hear from you now.

STATEMENT OF THOMAS A. SCHATZ, PRESIDENT, CITIZENS AGAINST GOVERNMENT WASTE, WASHINGTON, DC

Mr. SCHATZ. Thank you very much, Mr. Chairman.

I appreciate the opportunity to testify today on the Administration's proposal regarding regulatory consolidation and your and Senator D'Amato's proposed regulatory consolidation bill, S. 1633.

I represent the 600,000 members, nationwide, of Citizens Against Government Waste, or CAGW. The organization was created 10 years ago after the Grace Commission published its recommendations to make the Government more efficient. Since 1986, CAGW has saved taxpayers more than $250 billion, with another $76 billion in savings over the next 5 years. Many of our waste-cutting recommendations have been adopted by Members of Congress.

With the Vice President's National Performance Review, last fall, the Clinton Administration also recognized the importance of providing a better return on the investment of hundreds of billions of our tax dollars.

In late January, our founder, J. Peter Grace, sent a letter supporting the Administration's efforts to Treasury Secretary Bentsen. Mr. Grace reiterated his 1984 conclusions that, "The Grace Commission found the financial regulatory system, with its fragmented approach to regulation, inadequate to meet the demands of a rapidly changing industry."

Mr. Chairman, you and Senator D'Amato deserve the thanks of the American people for focusing attention on the need for consolidation of the Federal Government's banking regulatory system. This is simply a good Government issue and one that this Committee and the whole Congress should act on quickly.

Your Committee has documented more than 50 years of reports recommending consolidation of the bank regulatory system. Experts from both sides of the aisle and many Administrations agree that the current system is archaic, inefficient, and costly, and that consolidation would benefit consumers and improve the safety and soundness of the financial services industry.

Taxpayers are demanding action now to eliminate Government waste. There is nothing more frustrating for them, especially as they approach paying their taxes on April 15, 1994, than knowing there's a good and logical idea in Washington that's being thwarted by some special interest, or even worse, infighting among Federal agencies.

Your hearings will help make taxpayers aware of: the massive regulatory overlap among the four Federal banking agencies; inefficiencies in examinations, consumer protection, and recordkeeping systems, including simple items like the timing of applications and notices; and redundancy in administrative authority under Federal

banking laws resulting in inconsistent interpretations of almost 20 separate Federal statutes.

While this is enough to outrage taxpayers, the biggest waste of all is that nothing has been done. Differences of opinion should be set aside in favor of constructive action. Inside the beltway, turf battles cause taxpayers to lose faith in the ability of Government to make effective use of their hard-earned tax dollars.

One regulator is clearly better than four. Two regulators would still incorporate wasteful duplication and would also be more likely to engage in a civil war that would result in continued gridlock. One regulator would finally bring full accountability to the bank regulatory system.

Mr. Chairman, the Grace Commission advised that "significant economies are available by consolidating the regulatory agencies dealing with the banking industry" into a new Federal Banking Commission. The Grace Commission estimated that this consolidation would save taxpayers $99 million over 3 years. The Grace Commission estimated the cost of duplicative banking regulation in 1984 to be $292 million. They cited a total of 4,880 field examiners and overlapping field offices.

Today, the Government spends an estimated $1 billion a year on regulators, more than three times higher than in 1984, and employs over 12,000 examiners and support staff. This massive growth makes consolidation even more important. If we don't act now, how much bigger will this regulatory Goliath be in another 10 years?

In its conclusion, the Grace Commission said that, "The benefits in efficiency, uniformity, flexibility, consistency, and cost savings indicate that such a consolidation of the bank regulatory agencies into one is both necessary and appropriate."

Your legislation, S. 1633, as well as the Administration's proposal, would form a single regulatory agency out of the four Federal regulators for depository institutions. These agencies include the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Reserve Board. As proposed by the Grace Commission, this new entity would be called the Federal Banking Commission.

With a hodgepodge of regulations and regulators, taxpayers are funding a bloated and inefficient bureaucracy.

Last November, Secretary Bentsen reported that regulators from different agencies were examining a small bank in California. The examiners outnumbered the bank's employees, and their cars filled the parking lot so customers could not park to do business. The bank regulatory system is out of control and needs to be fixed.

Mr. Chairman, we don't need any more commissions or legislation in the future. Voters want change in Washington now. Eliminating duplication in the banking regulatory system is just what they have in mind.

Vice President Gore recently stated that, "Bank regulatory consolidation is in keeping with both the substance and spirit of Reinventing Government." He called it "a major step forward in the Clinton Administration's efforts to create a Government that works better and costs less."

To quote a well-known television commercial, Mr. Chairman, "just do it."

Thank you very much. I'd be happy to answer any questions.

The CHAIRMAN. Thank you very much for your presentation today. It's very helpful and the Committee is grateful for it.

Dr. Reinicke, you're here from the Brookings Institution. We'd like to hear from you now.

STATEMENT OF WOLFGANG H. REINICKE, RESEARCH ASSOCIATE, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. REINICKE. Thank you, Mr. Chairman.

It's a privilege for me to be back at this Committee to testify on the reform of the bank regulatory structure.

As you know, our work at Brookings does not attempt to represent any position of an institution or political organization. I have prepared a longer statement, but in my remarks this morning, I would like to focus on some of the critiques that have been put forward against reform.

Today's financial marketplace is characterized by a highly competitive domestic market environment, which has only been intensified by foreign competition and securitization. This has led to a process of consolidation among financial institutions and it is probably correct to assume that the process of consolidation will continue.

The principal purpose of public policy should be to guide and stabilize this dramatic change and ensure the competitive position of U.S. commercial banks in the domestic and global marketplace.

Regulations should promote a financial system that has internalized the underlying changes in the market structure by providing for adequate soundness and stability of the banking system.

Experience tells us that our regulators are often caught in the multilayered, overlapping structure of their own regulatory system. Different regulatory regimes force regulators to compete with each other in a market for regulation.

As one industry representative recently stated:

> If the Comptroller is giving me a hard time, it's nice to know that I can go to the State Bank Department and they will welcome me with open arms.

If the purpose of public policy is to evade it, we need no public policy at all.

Clearly, private sector input into the formulation of public policy is an important and central ingredient, but financial market regulation and supervision should not be the result of competing regulatory regimes.

Public policy should not be the consequence of the competition. It should be the cause for competition.

In addition to dealing with what has been described by all as a costly, burdensome, inefficient, and archaic system, a single independent Federal Banking Commission consolidates and concentrates the experience and expertise that both institutions have, ensures continued diversity of opinion, and meets the legitimate interests in participating in the policymaking process.

Let me now turn to some of the critiques that have been advanced against reform.

One states that reform would eliminate checks and balances. Such criticism is unfounded.

First, Congress can deal directly with problems of excessive power without recourse to several regulatory agencies. Second, an analogy of the fragmented regulatory system and the constitutional principle of separation of powers is false because the three regulatory agencies perform the same functions. One agency does not check or veto the actions of the other. It cannot, and the history of administrative rulings over the Glass-Steagall Act have attested to that fact.

Another criticism is that the proposed Commission is a monolith, a monopoly at great cost to the efficiency and flexibility.

First, a single commission is more efficient by consolidating bureaucratic waste and overlap and reducing costly and repetitive examinations. Second, first and foremost, markets should be efficient and flexible. To put that burden on regulators misses the point and defies their purpose. Third, regulatory quality, not quantity, counts in determining flexibility and global competitiveness, not the number of regulatory agencies but the nature of actual regulations and the manner in which they are implemented is important. Fourth, it is surprising that the Federal Reserve would join those that have suggested that the Federal Banking Commission would turn into a monolith. Not only has the Federal Reserve always been an advocate of its own independence, but the thought of having that independence compromised by a parallel body entitled to determine interest rates or operate a discount window among which banks could choose seems not just utterly unrealistic; it would defeat the very purpose of sometimes difficult and even controversial decisions and remove the Fed's accountability.

If monopolies in the domain of policymaking are so inefficient, then why, and in my view appropriately so, do we still have a single agency responsible for the conduct of monetary policy?

Critics have argued that a single regulator is likely to have a tendency to suppress risk-taking. Evidence from the savings and loan crisis, which was regulated by a single agency, does not confirm that. It has also been argued that history suggests that competition among regulators has tended to moderate incentives to be lax in supervision. Again, the history of the Glass-Steagall Act during the last 20 years suggests the exact opposite.

I don't mean to imply that Glass-Steagall could not be repealed. To the contrary, such a move, in my view, is long overdue. But the fact that it has been repealed de facto, but not de jure, not only raises questions about the apparent ability of the present system to ensure checks and balances, but also about the process of regulatory policymaking itself.

Some have said that banks would be less able to take on international competition. No evidence for this is available, however. If anything, it points in the opposite direction. For example, contrary to the impression that some previous statements have tried to give, bank regulation—that is the rulemaking function—in Germany and Japan does rest with one single agency and this is not the central bank. It is true that there is close informal and, in a few cases, formal cooperation between regulators and the central banks, but this is exactly what your reform proposal wants to achieve.

More importantly, it is not the structure of regulation that is the most important element in determining international competitiveness, but the regulations themselves and, equally important, the management, skill, and strategic choices of the banks.

Some say that reform would end the dual banking system. It is difficult to see how that would be the case.

States would remain the primary regulators of the banks they charter, thus preserving the integrity of the dual banking system. The fact that the knowledge and experience from State-level supervision will become an integral part of the Federal Banking Commission's policy actually strengthens the principal of duality.

Again, the dual banking system will not live or die because of the presence or absence of a particular regulatory structure. The fate of the dual banking system will be decided in the financial marketplace. The role attributed to consolidation is thus misplaced and obscures the real source of the problems and challenges for the dual banking system.

Finally, it has been argued that reform would impede the Fed's other responsibilities, such as handling financial crises and the conduct of monetary policy.

First, the banking industry accounts for only 25 percent of the Nation's total financial assets. Of those, the Fed currently supervises only 15 percent. Moreover, as has already been pointed out by others, in most of our recent financial crises, the Fed was not involved as a regulator but did handle the crises in a superior and flawless fashion.

Second, assuming for a moment a banking crisis has erupted, aspects of bank supervision no longer play any role, unless, of course, it can be demonstrated that only the Federal Reserve possesses the expertise as a regulator that could have prevented the crisis in the first place.

This also holds true for the conduct of monetary policy. Apart from frequent assertions, it has not yet been convincingly demonstrated how any useful information is obtained from the supervisory process that could not be obtained with another agency doing the supervision.

It would seem that the burden of proof on this matter rests with those that oppose reform. The critical condition for adequate and timely policy decisions is the criteria that guide data collection and immediate access by those that need the information. It is far less important as to who collects the information.

There may even be a conflict between regulation and monetary policy. Both policy domains involve political controversy, not the least because of the Federal Reserve's independence. When bold innovative action might be necessary, with respect to regulation, the political side-effects of taking such policy decisions might well lead the central bank to defer or at least postpone such action. The history of the Glass-Steagall Act points in that direction.

Indeed, according to officials from the Bundesbank, the central bank in Germany, they do want to get involved in regulatory issues and share responsibility as it may precisely interfere with their independence in the conduct of monetary policy.

Mr. Chairman, unfortunately, this debate indicates the same dynamic that has derailed every single attempt at reform over the

last 20 to 40 years. Short-term institutional interest to preserve turf continues to dominate over the long-term goal of building a regulatory structure that provides the foundation for a sound, stable, and globally competitive banking system in the United States.

Our regulators agree that the time has come to streamline the system. The fact that some resist a possible elimination of their regulatory powers is a separate matter, even understandable from their perspective, but it does not follow the principle of checks and balances. And I thus would urge you to proceed with the reform.

Thank you.

The CHAIRMAN. Thank you very much. Another very fine statement, very helpful to us.

Mr. Brumbaugh, we'll go next to you, and then to Mr. Barth.

STATEMENT OF R. DAN BRUMBAUGH, JR., ECONOMIST, AUTHOR, AND CONSULTANT, SAN FRANCISCO, CA

Mr. BRUMBAUGH. Thank you, Mr. Chairman. And thank you for the opportunity to testify today.

As with the other panelists, I support the Regulatory Consolidation Act of 1993 to establish a Federal Banking Commission.

I'll discuss it today, as an economist, in the context of the competitiveness of American banks, and the safety and soundness of the American banking system, and also the world of the Federal Reserve as lender of last resort and as chief instrument of monetary policy. I'll also discuss it in the context of what happened in the savings and loan industry and the Federal Home Loan Bank Board.

I think the appropriate context in which to think about this, in terms of American banking, is that American banking is engaged in a long-term decline, characterized by falling market shares, for example, in terms of the percentage of assets held by commercial banks and other depositories as a percentage of overall financial assets held by financial firms in the United States.

At the same time, we know there has been a temporary record profitability reported by the banking industry, in particular, which resulted from an unusual set of circumstances that is unlikely to continue. And that is the relatively sharp drop in short-term interest rates and the profitability primarily emanating from that is unlikely to continue.

Critics of your bill, sir, have focused, to some extent, on the fact that the Committee and the Senate and the Congress should be focusing, instead, on changing directly the opportunity for banks to be competitive by removing more obstacles to that competitiveness. It's my view that this bill establishing a Federal Banking Commission would have the effect of promoting that in many different ways.

It would, for example, separate several of the functions; deposit insurance, regulation, and lender of last resort. I believe that that would help in modifying difficulties having to do with crises.

In addition, I think that having one institution that's associated with regulation alone would tend, in my opinion, to promote competitiveness.

With respect to the Federal Reserve, in particular, I will advocate that the Committee should consider, in fact, dropping a member of the Federal Reserve from the Federal Banking Commission.

In my view, there is no need, in terms of economic strength of banks or the economic well-being of the Nation, to include a member of the Federal Reserve on the Federal Banking Commission. Indeed, from the standpoint of bank regulation, and, I believe, from the standpoint of the Federal Reserve's role as lender of last resort and monetary policy, it would be better if the Federal Reserve was not represented on the Banking Commission.

The reason for that, primarily, is that the Fed's role, in terms of developing lender of last resort policy or monetary policy, does not require, in any way, shape, or form in an economic sense, either in theory or from empirical evidence, that the Federal Reserve should be involved in the actual regulation and supervision of banks.

In terms of their role as lender of last resort, the Fed is to provide liquidity to institutions that are solvent but are experiencing difficulties. The purpose of that is in order to prevent the prospect of runs against solvent but illiquid banks. For that purpose, the Federal Reserve needs information but certainly does not need to have a direct role in the regulation and supervision of banks. And, certainly, under the bill, as it's now structured, they would have greater access to information than, in a sense, they do now.

As the previous panelist noted, the Fed actually regulates only 15 to 20 percent of the banks in the country by assets, and under the current proposal, it would have access to all the information that's guaranteed all bank regulators at this time.

In terms of monetary policy, the purpose of monetary policy is to promote sustainable economic growth, high employment, and stable prices. Again, there's no reason why, in economic theory or in economic empiricism, the Federal Reserve needs to have access, directly, to regulatory function for banks in order to do that.

Again, they need to have information on financial service firms. They have that from many other sources and dealing with many other financial institutions, and they certainly don't need to have bank regulatory and supervisory functions in order to provide that role.

The CHAIRMAN. Let me just stop you there.

If you accept what you've just said over the last 3 or 4 minutes, then what would motivate the Fed to hang on so tightly to these functions, and, in fact, Mr. LaWare's even suggested broadening them out, that they'd like even more bank regulation than they presently have.

I mean, what, in light of your analysis as a professional that these things are not needed, is it? Is it simply defending the status quo or maintaining a certain degree of prestige and strength by virtue of more outreach and more connecting links to more parts of the economic system? What basis would there be left, if you take your arguments, for the Fed to fight so hard against any change here?

Mr. BRUMBAUGH. I reviewed the most recent annual report of the Federal Reserve and, insofar as I can understand how the numbers are put together, approximately 3,300 members of the Federal Re-

serve Board staff are associated with bank regulation and supervision.

The CHAIRMAN. Thirty-three hundred?

Mr. BRUMBAUGH. Approximately.

The CHAIRMAN. Right.

Mr. BRUMBAUGH. And that would be considered the nonsupport staff people who are actually engaged in the operation of regulation and supervision. On the other hand, there are approximately 1,200 members of the Federal Reserve Board staff who are delegated to monetary policy and other aspects of the Federal Reserve.

In addition to that, as far as I can tell, approximately 90 percent of the 3,300 individuals who are associated with bank regulation and supervision, are at the 12 Federal Reserve Banks throughout the country.

So, my view is that the concerns expressed on behalf of the Federal Reserve being part of the bank regulatory system has to do with maintaining that bureaucratic empire and not with lofty concerns about monetary policy and their role as lender of last resort.

The CHAIRMAN. Quite interesting. You just stated that 90 percent of the 3,300 regulatory type employees are out in the 12 banks around the country?

Mr. BRUMBAUGH. That's correct.

The CHAIRMAN. So they're not here performing any centralized function.

So if you took them completely out of the regulatory business, and we're not proposing that, but if you did and they, in effect, lost 3,300 employees, and kept the 1,200 employees here in Washington, they would feel they'd been put on a diet to shear off that much personnel.

But it's your view, professionally, that the Fed is really driven more by protecting this domain and this fifedom?

Mr. BRUMBAUGH. Yes, I do.

I reviewed, in preparation for this testimony, thoroughly, I think, the statements that have been made and the criticisms that have been made with respect to the role of the Federal Reserve and the Bank Consolidation Act. I listed seven of those in my statement.

I believe that it's correct to say that, on the basis of theory and economic empiricism, there is no basis, whatsoever, in any material way, to support the proposition that in order for the Federal Reserve to conduct monetary policy or its role as lender of last resort, it needs to have any bank regulatory examination or supervisory function.

The key issue, it seems to me, is the Federal Reserve's access to information from the banking system.

The CHAIRMAN. Right. Which they need and which we preserve fully.

Mr. BRUMBAUGH. That's true. My view, however, is that it's not even necessary for a member of the Federal Reserve Board to sit on the Commission, and the reason that it's almost better that they not do that is because it is important, especially in the handling of crises, that the lender of last resort do one and only one thing. And that is lend to the solvent banks that are experiencing liquidity problems.

They would be more likely to stay the policy that needs to be followed, in order for the Fed to do that role, if they were independent than if they were involved in regulation.

The notion of, I'll tie in what I was going to say about the role of the Federal Home Loan Bank during the S&L crisis here, them being more likely to do that if they were completely independent because it would eliminate the possibility and the incentive for the Federal Reserve to become part of laxity and forbearance in the design of regulation to obscure a crisis which they might arguably be accused of creating in the first place by virtue of their regulatory role.

That was a primary problem in the S&L debacle, a role in which the Federal Home Loan Bank Board was not only the regulator but also the deposit insurer. And, just like the deposit insurer, it is better if the lender of last resort is separated from the regulatory process.

The CHAIRMAN. I think there's a lot to be said for that. And it keeps the incentive in place to blow the whistle sooner on bad practice, and to try to head things off.

It's interesting that that's the way the Bundesbank operates in Germany, does it not? They are a central monetary authority. They've got the duty to deal with systemic risk there, but they're not into bank regulation per se. Mr. Reinicke's made that point here today.

So you have a working model of what many consider to be the premier monetary policy institution in the world today, namely, the Bundesbank, that's not all tied up with 3,300 employees out across the country, doing bank regulation.

I'm also struck by the fact of your percentages, when you say, I didn't write them all down, but with the banks having roughly 25 percent of the financial assets, and the Fed looking after banks that only comprise a small percentage of that 25 percent, the notion that somehow or another that gives them the critical interdiction in the financial system by virtue of their regulatory power, when they could otherwise have that data anyway, have access to it, I think is really a transparent argument.

I think the Fed is a little like the fellow you see in the movie the Wizard of Oz, who at the end creates all the huffing and puffing and he's behind a curtain creating this image of something all powerful, but it's all smoke and mirrors.

I'm not talking about monetary policy, systemic risk, or the payment system; I'm talking about bank regulation.

And then, when you pull the curtain back, you see, instead of being this big, powerful, fearsome force, a standard bureaucracy with 3,300 people who get up every morning and receive a Government check, and who'd like to keep doing it. For at least 40 years, every single study that's been done has repeatedly endorsed the consolidation concept that we've talked about.

But I have to say, I think you've made a very compelling set of arguments.

Let me let you finish, and then I'm going to ask Senator Shelby if he has an opening comment before we hear Mr. Barth.

Did you have more to say, Mr. Brumbaugh?

Mr. BRUMBAUGH. Yes. I'll just briefly finish.

I know that, in particular, Senator Shelby's concerned about the size of the Federal Banking Commission. And what I would like to say is that the checks and balances that are associated with the system as it would evolve, I think, take care, primarily, of those concerns.

In our Government, the safeguards against undue power are not tied to size or scope but a system of checks and balances. I believe that the new system would have a durable and good set of checks and balances, in which you would have a separate lender of last resort, a separate deposit insurance agency, a separate regulatory agency, all of which is overseen by Congress.

In addition to separating the Federal Reserve Chairman from the system, I would also recommend that the Committee consider eliminating the position for the Secretary of the Treasury for much the same reasons that I stated earlier.

I believe that in the S&L crisis, for example, as I also say in my statement, and perhaps we could discuss it later, the Federal Home Loan Bank Board and the Treasury Department acted in unison in many of the situations involving the difficulties of the S&L industry.

This is less likely to occur, the greater the separation. It occurred in that case even though the Federal Home Loan Bank Board was separate from the Treasury Department.

Having answered your questions, Mr. Chairman, and noting that this part of the testimony has taken a little lengthier time than perhaps others, I will just close and perhaps take questions.

The CHAIRMAN. Very good, thank you. Very good statement.

Senator Shelby.

OPENING COMMENTS OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Mr. Chairman, I have been to another meeting with the Secretary of the Navy. I'm sorry I was late because we have a distinguished panelist here. We've got a distinguished panel and a distinguished panelist from Alabama, Auburn University. I wanted to welcome him to the Committee, even though I know you already have. Welcome, Professor Barth.

The CHAIRMAN. Thank you.

Mr. Barth, we'd like to hear from you now.

STATEMENT OF JAMES R. BARTH, LOWDER EMINENT SCHOLAR IN FINANCE, AUBURN UNIVERSITY, AUBURN, AL

Mr. BARTH. Mr. Chairman, Senator Shelby, I appreciate the opportunity to appear before you today to provide my views on the consolidation of the Federal bank regulatory agencies. This is an important and timely hearing because the current bank regulatory system clearly needs to be restructured.

At present, single banking organizations are subjected to overlapping and conflicting Federal regulations. The responsibilities of regulating and insuring banks, moreover, are commingled in the same agency.

Now that banks and savings institutions are reporting record profits, it is time to correct these and other problems that impede innovation and efficiency in the U.S. banking industry.

The current regulatory structure is archaic and bizarre, reflecting the fact that each of the four bank regulatory agencies was established at different points in time over the past 130 years in response to specific problems.

Since their establishment, however, the financial marketplace has changed dramatically, including the fact that the distinctions among the different banks and savings institutions have become significantly blurred.

As a result, nobody would design such a structure today. Indeed, the bill introduced by Senators D'Amato and Riegle, S. 1633, provides for a far more sensible Federal bank regulatory structure.

This proposal for regulatory consolidation provides for three separate and Federal banking agencies, a regulator, the Federal Banking Commission, an insurer, the Federal Deposit Insurance Corporation, and a central bank, the Federal Reserve Board. Such a proposal permits the Federal Banking Commission to focus on safety and soundness issues. The FDIC, the insurer, to focus on containing potential losses at troubled institutions. And the Federal Reserve Board to focus on overall financial stability.

It also provides that all examinations and other related information collected by the Federal Banking Commission would be made available to the Federal Reserve Board.

This last provision is included to ensure that, under the proposed consolidation, there will be as much information as currently available to the Federal Reserve Board to enable it to fulfill its central responsibility.

While this particular regulatory structure exploits the benefits of the division of labor, it nonetheless preserves checks and balances through the sharing of information and thus cooperation that must occur for each agency to fulfill its responsibilities.

The benefits of consolidation, such as under S. 1633, are, in my view:

First, more uniform information can be obtained in a more timely manner with a single Federal regulator of each and every banking organization to enhance the regulation of banks and savings institutions.

Second, laws and regulations can be applied in a more consistent and timely manner with a single Federal bank regulator of each and every banking organization.

Third, the public would finally know, with greater certainty, whether it is the regulator, the insurer, or the central bank to turn to for information regarding specific problems.

Fourth, the current Federal bank regulatory structure has both the FDIC and the Federal Reserve Board involved in the regulation of banks. This situation creates potential conflicts when the same Federal regulator that is responsible for making decisions about the safety and soundness of banks and savings institutions, is also responsible for the condition of the insurance fund, discount window borrowing, or overall financial stability.

Consider the case of the S&L industry during the 1980's. At the time, the Federal Home Loan Bank Board was responsible for both regulating and insuring S&L institutions. As everybody now knows, this dual responsibility produced disastrous results. A lesson to be learned is that separating responsibilities among the Fed-

eral bank regulatory agencies may better protect the public through greater checks and balances, as under S.1633.

The consolidation of the bank regulatory functions of the four current Federal agencies into one entity should lessen total regulatory costs. A single and more homogeneous set of examiners, supervisors, and reports should yield cost savings that flow directly to the regulated institutions and, in turn, to their customers.

Three potentially important concerns have been expressed over the establishment of a single Federal bank regulatory agency, which I now would like to comment upon.

First, some have expressed the concern that, with a single Federal bank regulatory agency, one is simply setting the stage for another S&L-like debacle.

The specific concern is that, instead of involving just a single type of depository institution, when there is a regulatory blunder, because of the existence of multiple regulatory agencies, one now would potentially be confronted with the collapse of all commercial and savings bank institutions with only one regulatory agency.

But, as already indicated, the commingling of the regulation and insurance functions within the Federal Home Loan Bank Board was an important factor in the S&L disaster.

The proposed consolidation under S.1633 avoids this potential problem by putting these two functions in separate and independent agencies. This allows the regulatory agency to encourage innovation on the part of well-capitalized institutions within the guidelines of safety and soundness regulations while the insurance agency serves as the check on excessively risky activities by taking appropriate action against inadequately capitalized institutions so as to contain its own risk exposure.

Second, some have expressed the concern that, without hands-on supervisory and examination responsibilities, the Federal Reserve Board's ability to prevent an event that adversely affects one part of the banking system from cascading throughout the entire financial system will be impeded. Several remarks about this concern are in order.

First, under S. 1633, the Federal Reserve Board completely retains its ability to provide liquidity through the discount window and through open market operations under any and all adverse circumstances.

These are the functions necessary for the Federal Reserve Board to contain systemic risk, and more generally, to provide for overall financial stability.

Second, supervision and examination responsibilities are not necessary for conducting monetary policy, since the central banks in many countries are not assigned such responsibilities, as in the case of the German Bundesbank.

Third, the availability of supervision and examination information to the Federal Reserve Board should not diminish since the proposed consolidation under your bill, Mr. Chairman, requires that all such information collected by the Federal Banking Commission be made available to the Federal Reserve Board.

Indeed, since the Federal Reserve Board currently only supervises and examines a relatively small percentage of all depository

institutions, and not even all of the biggest institutions, the availability of information to it may actually improve.

The depository institutions' share of the financial assets held by all financial service firms in the United States has declined from 65 percent in 1950 to 34 percent in 1993. Yet, nobody appears to be arguing that the Federal Reserve Board needs to supervise and to examine all the non-depository institutions that today account for two-thirds of the total assets of all financial service firms.

The Federal Reserve Board does need information to fulfill its central responsibilities, which means information collected from a wide range of sources, both domestic and foreign. But hands-on participation in the collection of all the important and relevant information seems both infeasible and unnecessary to serve as lender of last resort and to conduct monetary policy.

Fourth, some have expressed the concern that a single Federal bank regulator will lead to the demise of the dual banking system. More specifically, the concern is that a single bank regulatory agency, like the Federal Banking Commission would regulate State banks in the same manner as national banks, thereby eliminating the value of a separate State charter.

However, the proposed consolidation, under S. 1633, does not provide for any additional authority to the Federal Banking Commission over State-chartered institutions. Institutions will still be free to seek a State, rather than national, bank charter with the State, in such instances, becoming the primary regulator.

In conclusion, I support the consolidation of the four Federal bank regulatory agencies, and I believe S. 1633 provides a sensible way to restructure the present Federal regulatory system.

However, I also believe that: One, the new Federal bank regulatory agency should be politically independent, which means it may be appropriate to exclude the Secretary of the Treasury as a commissioner on the Federal Banking Commission; and two, the new Federal bank regulatory agency should let commercial banks and savings institutions compete more freely in the financial marketplace by not curtailing their existing activities and by not prohibiting innovative products and services from being offered in the future by well-capitalized institutions.

After all, deposits insured by the FDIC today fund only 17 percent of the total assets of all the financial service firms that I list in a table attached to my prepared statement.

Thank you, Mr. Chairman, and Senator Shelby.

The CHAIRMAN. Thank you, Mr. Barth.

Again, very important and valuable testimony, and I appreciate the time and the effort on your part and all of you that have spoken.

Senator Shelby, do you have questions at this time?

Senator SHELBY. I've got several, Mr. Chairman. I appreciate you deferring to me.

I want to commend the Chairman again, with this panel, for calling this series of hearings. He's been diligent. He's been at these Committee hearings all week, while some of us have been at other Committee hearings and on the floor, and he's working toward this end.

Mr. Chairman, I agree with a lot of—although I don't support the bill that you've brought forth for several reasons—I agree with the objective here. I think we need to consolidate as much of the regulatory agencies, as many of them as we can, without impeding the role of the Federal Reserve.

I can see how we could consolidate at least three agencies into one, in other words, have two agencies and have the role of the Federal Reserve preserved.

That is the question. I don't believe a bill—this is my own opinion—I don't believe the bill as written now is going to move in the Congress, leaving out the role of the Federal Reserve here.

I think that the Federal Reserve has a sterling reputation. They're not perfect, but this bothers a lot of people, including this Senator and a lot of people on this banking panel.

I hope that we can make some progress, though. The Chairman has, earlier in the week, when we had the Fed and some others here, talking about how we can make the bill work.

We all read the tea leaves politically up here, and maybe we interpret them differently, but I share the objective of trying to consolidate, and make agencies work. We have too many agencies out there now. OCC, OTS, and FDIC. It looks to me like they could be made into one agency without a lot of fuss, keeping the role of the Federal Reserve.

Mr. Barth, I think your views are a little different than that, but what's wrong with keeping the role of the Federal Reserve and consolidating the other three agencies?

Mr. BARTH. Senator Shelby, I understand your concerns and appreciate those concerns, and I think some of your concerns I actually share.

I'm concerned about political independence, and that's why I suggested it may be appropriate to exclude the Secretary of the Treasury from the Federal Banking Commission.

Senator SHELBY. I like that.

Mr. BARTH. However, I do believe there are numerous benefits from consolidation, going beyond, apparently, your, the extent of consolidation that you advocate, so I think one's moving in the right direction to get anything.

Senator SHELBY. Let me ask all of you. Isn't it very, very important, not just in today's climate but—we all know the political climate in Washington at the moment; it changes from time to time—but always to have the regulatory agencies above politics as much as we can get them above politics?

We know there's a political equation during the appointment and the confirmation process. There's even a political equation involved in the Federal Reserve, although their terms are longer. But the political integrity or the integrity—let's leave out the politics—the integrity of our banking system is very, very important and should be so far above politics, at least as far above them as we can make it happen. Do you agree with that, Mr. Barth?

Mr. BARTH. Yes, I do, Senator.

Senator SHELBY. What about you, Mr. Brumbaugh?

Mr. BRUMBAUGH. It's impossible to disagree with your statement as you've said it. But I think it's important to go back to some contentions you made earlier with respect to the Fed, if I may.

Senator SHELBY. Go ahead.

Mr. BRUMBAUGH. You made the comment that it was important to have the Federal Reserve involved in bank regulation because it's a highly respected agency.

Senator SHELBY. Absolutely.

Mr. BRUMBAUGH. There are many highly respected agencies throughout the Government. Just the fact that an agency is respected doesn't seem to me to be any basis upon which to make a contention that that agency ought to be included in bank regulation. In fact——

Senator SHELBY. But it's in bank regulation. The Fed is involved in it now in a sense.

Mr. BRUMBAUGH. I would contend, Senator, that the basis upon which to evaluate whether the Fed should continue in bank regulation has to do with bank regulation, the role of the Fed in bank regulation, the role of the Fed as lender of last resort, and the role of the Fed in monetary policy.

As I said in my prepared statement and as I said in my opening remarks before you arrived, there is no empirical evidence in economics and there is no theory in economics, and there is no experience anywhere in the world, including the United States, that indicates, economically, that there is a need to have the lender of last resort involved in bank regulation and supervision, or the monetary policy agency involved in bank regulation for the purposes of lender of last resort role or monetary policy role.

By the same token, there's no reason, in terms of bank regulation, that the agency that handles those other functions needs to be in bank regulation.

Indeed, you can argue primarily—well, not primarily but based, in part, on the experience that we had in the savings and loan debacle and the turmoil of the 1980's and the early 1990's in bank regulation, that it's better to have the lender of last resort out of the bank regulatory and supervision role because it minimizes the likelihood of two things. One, that there's going to be doubt about when the lender of last resort is going to lend to illiquid but solvent banks. Two, it minimizes the likelihood that there's going to be Fed pressure for regulatory laxity and forbearance as there was in the banking crisis of the 1980's and 1990's.

Senator SHELBY. Of all the agencies we're talking about—OCC, OTS, FDIC, and the Fed—do you disagree with me that the Fed has, overall, more respect, not only in the banking community but from the American people than any of the others?

I think that's important owing to what the perception that the people believe the role of the Fed and the independence of the Fed is.

Mr. BRUMBAUGH. I think the appropriate way to answer your question is to say it this way. We're not here to decide whether we're going to have a bank regulatory system operated by either the Federal Reserve or the Office of the Comptroller of the Currency.

Senator SHELBY. We already have it, don't we?

Mr. BRUMBAUGH. What we're here to discuss is whether we're going to have a system in which the Federal Reserve Board is going to be responsible for the policy of lender of last resort and

monetary policy, and whether we're going to have a Federal Banking Commission responsible, primarily, for bank regulation, examination, and supervision.

There's no reason in the world to believe, a priori, before anything is done, that that Federal Banking Commission is going to be less reputable, less respectable than the Federal Reserve Board.

Senator SHELBY. Why not retain the role of the Fed, going back to my other statement, that it has now, and consolidate these other three Federal agencies into one? That way you wind up with two instead of four.

Mr. BRUMBAUGH. The positive case for keeping the Federal Reserve Board out of bank regulation is that, traditionally, first of all, in terms of bank regulation and supervision, the Fed has been the least likely to respond appropriately to crises that develop in terms of the overall competitiveness in banking.

It has been the most reluctant——

Senator SHELBY. Give me an example.

Mr. BRUMBAUGH. The biggest problem that we have in banking today is the fact that banking cannot adapt to developing domestic and international competition in financial services fast enough in order to survive.

The Fed, traditionally, has been the Federal agency least likely to approve of and support innovation in banking regulation and supervision that would allow banks to adapt appropriately and quickly enough to developing competition.

Senator SHELBY. There are statutes out there that are impediments to that, aren't there?

Mr. BRUMBAUGH. Within the interpretation of those statutes, the interpretations that are given to the bank regulatory agencies, traditionally, the Federal Reserve has adapted more slowly, and to the detriment, over time, of innovation and adaptation to competition in banking.

Senator SHELBY. I would submit to you that, although the Fed is not perfect, overall there's a lot of confidence, not just by this Member, but by the American people in the Fed and the role they play. And that is one of the political problems we're having in this Committee in dealing with the consolidation here. I don't believe, and I'll say it again, it's my own opinion, and we all differ, I don't believe this will move, knocking out the role of the Fed in supervision.

I'm trying to see, as the Chairman said, if we can find some common ground, consolidate three agencies into one and keep the role of the Fed.

Doctor.

Mr. REINICKE. Could I just come in on this? I fully support what Dan Brumbaugh said. However, I truly realize the political realities of the consolidation process.

And in answer to your question, I would say that in many ways, the Fed's role is preserved by that proposal. It, obviously, is preserved in the sense that all the other functions that the Fed has are untouched and the Fed is on the Federal Banking Commission. It participates and takes participation in the deliberations on bank regulation.

Senator SHELBY. It's represented, I agree with you, Doctor. It would be under the proposal, as I understand the Chairman's bill, they would be represented. But their role would be diminished.

Mr. REINICKE. The important point is that this takes place under one single roof. The regulators don't compete with each other, which has been so detrimental to the system. But, putting them under one roof, you still allow for the diversity and the experience even though it is consolidated and can be developed there.

Let me just make one more point about the inability of the American banking system to adopt to international competitiveness. I would fully support that point and, indeed, as I mentioned in my testimony, there is also a conflict between monetary policy and regulation. This is precisely why the Fed has been so hesitant in allowing banks to adjust to the realities of competition, because the Fed was and is afraid that this may impede its independence as the only responsible actor for making monetary policy.

Through the backdoor of its regulatory responsibilities, which are accountable to Congress, there is an impediment on its monetary responsibility, and this is why the Fed has been consistently non-adaptive to the realities of the marketplace contrary to the Comptroller of the Currency and the Federal Deposit Insurance.

Senator SHELBY. When the Federal Reserve was set up, you all know better than I, in the history of the Federal Reserve, the role it was slated to play. It was slated to be independent as much as it could, independent of the whims of politics day to day, of the Republican Administration, the Democratic Administration, this Senator, that Senator, but to have a strong monetary policy, a sound one by the United States of America.

Mr. REINICKE. That's correct. But the principal role of regulation came much later; namely, when the Fed was allowed to be the supervisor of bank holding companies, which was long after, many, many years after the principal purpose of the Fed.

Senator SHELBY. They didn't have bank holding companies when the Federal Reserve was initially created. Is that correct, Doctor?

Mr. REINICKE. That's correct.

Senator SHELBY. The game has evolved and the rules change, not only as to just new entities, bank entities, but the regulations change because of the new products that come out, as you well know, better than I.

Mr. Chairman, thank you for your indulgence.

The CHAIRMAN. Senator Shelby, interestingly, one other point was made, that I heard for the first time today, that fits into this context. I know you and I have a little different view on this issue. But Mr. Brumbaugh has gone back and actually done an analysis of the Federal Reserve's balance sheet of personnel, and these were the rough numbers he had. I found these surprising.

The Federal Reserve personnel, a rough division of people that work on systemic risk, the payment system, and monetary policy, have about 1,200 employees in and around Washington.

It turns out that, for this rather small bank regulatory function, they have percentage-wise, the number of assets they oversee, there's 3,300 employees out across the country in these 12 Federal Reserve districts.

So there's a very healthy little army of Fed people out across the country. And the reason we got to that, was because I asked the question, why would the Fed fight so hard on this issue?

The answer that Mr. Brumbaugh gave, in his opinion, was that there's a lot of bureaucracy out there, a lot of people, who put on the Government feedbag each day. This was part of the issue that Mr. Peter Grace and his group, as Mr. Schatz pointed out, were concerned about.

In other words, you've got this army of people out there who are on the Government payroll, and you need to ask, do you really need them all? I can see why John LaWare and others would not have much appetite for that, just on the shear matter of turf preservation and things like that. It's almost a natural bureaucratic reaction.

Senator SHELBY. Can I comment on that?

First of all, I don't represent the Fed. I know them, I know most of the members in a professional sense, like the Chairman, because they're over here a lot and we deal with them a lot.

I don't believe, myself, that the reason the Fed is objecting to this bill as it's written is to hold 1,200 jobs or whatever it is.

The CHAIRMAN. Thirty-three hundred jobs.

Senator SHELBY. Or 5,000 jobs. I don't believe that at all. I think everywhere we can cut out jobs in Government and make the system work more efficiently, we need to do it.

The Chairman and I both share a role there and a philosophy, but I don't want to cut out jobs by cutting the role of the Fed out of something that I think they do a superb job at. I think it goes to the role they play in the regulation of some of our banks.

It's my understanding, Mr. Chairman, that the holding companies which are regulated by the Federal Reserve control about 94 percent—that number sounds high—94 percent of the banking assets in the country. Is that correct, about right? That's the GAO's estimate. That is a lot of assets. I think that would be taking a role away from the Fed that I think, overall, they do well.

The CHAIRMAN. What is the answer to that, Mr. Brumbaugh or Mr. Barth?

Mr. BARTH. It's the overwhelming majority of the assets, but the Federal Reserve, despite having some regulatory power with respect to the activities of the bank holding companies, does not examine all those banks within the holding companies. That's one of the problems that's identified by a number of people, which is their overlapping responsibilities.

Different bank regulatory agencies regulate different parts of the holding company structure. Therefore, it may be that information is not made available, and there's a lack of consistent regulation. Things may fall through the cracks.

Senator SHELBY. Mr. Chairman, would you yield for 1 minute?

The CHAIRMAN. Yes.

Senator SHELBY. Would we be making progress, maybe not getting to the ultimate goal that some of you have, but would we be making progress in the Congress if we were to go, again, from four regulators to two?

If we kept the role, just for the sake of argument now, of the Fed, but consolidated the other Federal agencies, three into one, would

we be making progress? In other words, going from four to two, to see how that works, to see how strong this agency is that we would consolidate, this newborn entity, or recreated entity, wouldn't we be making progress and being careful at the same time?

Professor Barth.

Mr. BARTH. I certainly——

Senator SHELBY. I didn't say that's what you believe or what your goal would be, but I'm saying if we did that, if that was the will of the Congress.

Mr. BARTH. Senator Shelby, I've clearly expressed my views as to how far one should go to make the most progress in my prepared statements and my comments. But, I do agree that going to the point of consolidation of some of the regulatory agencies is indeed progress.

Mr. REINICKE. I would tend to disagree. I would be careful. We don't remove the underlying problem of competition in regulation. If you present it as a test as to who is the better one, we once again fall into the trap of each of the agencies trying to perform short-term policies that preserve their institutional turf, but don't deal with the underlying fundamental problems of the future of the American banking system, because, eventually, if this is a test, at some point in the medium term, we're going to evaluate who was the better one.

So I don't think that this will assure policy that looks into the long-term stability and competitiveness of the banking system. We will see many of the same problems that we see now among the three or four.

Senator SHELBY. Would we be better off if we abolished those three agencies and consolidated all bank regulation in the Federal Reserve?

Mr. REINICKE. It is my understanding that the Fed does not want that.

Senator SHELBY. I didn't ask if they want it.

Mr. REINICKE. I don't think so, for the reasons that I stated, because there's the potential for a serious conflict between monetary policy and regulation.

Senator SHELBY. Thank you, Mr. Chairman.

The CHAIRMAN. This is a very important question that's been going back and forth here. The conflict between monetary policy and bank regulation is somewhat analogous to what happened in the old Federal Home Loan Bank Board where they had the insurance power and the regulatory power.

In a sense, you build a conflict that doesn't necessarily lead you to good policy. I think, to the extent that you can separate these items and create your balance of power, with the insurance function one place, the regulatory function another place, and the monetary payment system authority and the systemic risk authority in another place, letting those three operate with full exchange of information, they can process this data 97 ways from Sunday to monitor what's going on. And if there's a troubled institution, they can get even closer than that.

But what I see going on here is that the Fed is putting up in the front window the systemic risk issue, the payment system issue, and the monetary policy issue, and all the while tending to the care

and feeding of these 3,300 employees that are out across the country.

That really preserves the Fed's turf. I mean, that's essentially 75 percent of their personnel. I can see why they're reacting the same way that every single bureaucracy reacts when they're asked to get rid of ten people, 50 people, or 100 people. They are hanging on for dear life.

So John LaWare is out there. In fact, their strategy is the reverse. They're saying, "Well, now we don't have enough people." They want more work to do as a way of, in a sense, insulating themselves from the need to have to go on a bureaucratic diet.

But if we're going to hold any agency of Government out to be immune from intelligent consolidation, and the shearing off of overlapping and duplicative people, we're never going to make much progress. I think that's part of the problem here. I think this is, in large measure, a bureaucratic argument, as much as anything else.

Senator SHELBY. Mr. Chairman, if you'd yield to me?

I disagree with you on that. I'll tell you what. If we're trying, if we would save money by knocking out 3,000 or 4,000 jobs, I'd rather knock them out of the House and the Senate payroll than the Federal Reserve, or any of the regulatory banking agencies that do a lot to give confidence to our banking system.

If we're going to try to save jobs, maybe we ought to do it here. I appreciate the role of the Fed.

Thank you.

The CHAIRMAN. I'm going to just ask Mr. Brumbaugh, because you made this point before Senator Shelby came, your words are, I think, better than mine on this.

When you laid out that differentiation of personnel, between the study that you did of their work force, the number that are out in the Federal Reserve Banks versus the ones that are in here, tending to these major system functions, would you repeat how you think that is at the heart of some of their resistance to change here? Just restate that point you made.

Mr. BRUMBAUGH. An economic analysis of the role of the Federal Reserve in the three functions we've been discussing today, that of bank regulation and supervision being one, the lender of last resort a second, and third, its role in monetary policy, I'll say it one more time.

You cannot find anywhere in economics, in theory or in empirical evaluation, arguments that buttress the case that the Federal Reserve needs to have bank regulatory and supervision roles in order to provide appropriate policy as lender of last resort and as the agency for monetary policy and vice versa. It does not exist, notwithstanding the fact that the Fed is a highly respected Government agency.

In handling lender of last resort activities, the Federal Reserve has a very specific role. That role is to lend to banks that are solvent but experiencing liquidity problems due to depositor withdrawals, funds adequate to handle those withdrawals. In that role, all it needs is information from the bank regulatory agencies that allow it to have enough information to know that they're lending to a solvent bank.

If the bank is not solvent, the Fed has no role. The role then goes to the deposit insurance agency which is designed to close the insolvent and illiquid bank.

In terms of monetary policy, monetary policy deals with maintaining stable and high employment, stable and high overall real economic output, and stable prices. There's no evidence that the Fed needs to have a direct regulatory role in banking in order to provide that. Indeed, it has no similar role in any other aspect of the economy.

Many financial aspects, as Dr. Barth stated extremely well, are much larger and much more important than the role of the banking agency.

Then, with respect to the actual regulation and supervision of federally-insured depository institutions, first of all, the lender of last resort and monetary policy, with the exception of the one role that I said, for a lender of last resort, the Fed has no role, whatsoever, in its bank regulatory and supervisory capacity as lender of last resort and in monetary policy.

The issue then becomes, are there any benefits to be had if the Federal Reserve is not in the business of regulating, examining, and supervising banks? And the answer is, there is. The primary one, in terms of difficulty in times of turmoil and in times of difficulties for banks, is that it is much better to have a lender of last resort that is out there and is saying to the bank regulatory agency, these are the terms under which we will lend to your member banks, the banks that you regulate, if they become illiquid. This is our only role and that's what we're going to do.

You don't want the Fed, because it has previously had responsibility for bank regulatory policy, which arguably could have caused the turmoil in the first place or contributed to it, to be in a position of conflict of interest where it needs to abet that regulatory mistake by lending to institutions which are illiquid and insolvent. Which, Senator Shelby, it has done.

So there's a real purpose to have the lender of last resort separated from the bank regulatory and supervisory staff, just as the Federal Deposit Insurance Corporation would be under this legislation sponsored by Senator Riegle.

Let me just say, the major benefit that would accrue under the approach that you suggest is a moderate averaging, leavening, moving in the right direction approach, which would not come from the consolidation of the bank regulatory agencies, but from the separation of the Federal Deposit Insurance Corporation from bank regulation, for much the same reason that we need to separate out the lender of last resort, and that is the following:

The Federal Deposit Insurance Corporation, just like the Federal Savings and Loan Insurance Corporation in the savings and loan debacle in the turmoil of the 1980's with the banks, abetted and actually created regulatory laxity and forbearance because it didn't have the reserves in order to close all insolvent banks.

You'll have a better system if the Federal Deposit Insurance Corporation, which has no regulatory responsibility and no way to get its fingers into regulatory laxity and forbearance and simply does one thing, makes certain that it has the reserves to close all insol-

vent banks, and makes certain that the Federal Banking Commission knows that that's the role and that's what it's going to do.

The CHAIRMAN. But then I asked you this question. Why would the Fed fight so hard against this? That's when you got into this division of all these people across the country, and I think that's a very telling point.

I noticed, when the Fed was in the other day, they didn't talk about where their people are or what they did. Probably because that's not a very attractive argument to advance from their point of view.

Mr. BRUMBAUGH. If one makes the economic argument that, on the basis of substance, on the basis of bank regulation per se, including examination and supervision, on the basis of deposit insurance per se, on the basis of developing a healthy and competitive banking industry per se, in economics, if on the basis of an economic analysis of the role of monetary policy and the central bank in monetary policy, if on the basis of an analysis of the Federal Reserve as lender of last resort, there's no support for the proposition that the Federal Reserve should be in the business, then what does that leave one with? Especially when one has a bureaucratic empire in which, by a ratio of roughly three to one, the staff is in bank regulation and supervision and not in monetary policy and the role of lender of last resort.

The CHAIRMAN. I'm troubled by that, and I'm also troubled by this other, larger point about what I would call the slipping and sliding problem. And that is, when you're into the supervision side of bank regulation and you're also the lender of last resort, I think there's a tendency to tidy up your mistakes.

If you make mistakes over in the one area by not being farsighted enough or by forebearing too much in bank regulation and supervision, and then you end up with a problem over in another area with either systemic risk, or having to come in and intervene in some way, there's an inherent conflict in that.

I think most bureaucracies tend to want to tidy up the record so that they can avoid acknowledging other policy mistakes they've made.

We're dealing with that right now in the Defense Department with respect to exposure of veterans in the Persian Gulf War to, I think, chemicals and possibly biological weapons, where we've now got a vast number of sick veterans.

The Defense Department can't see the problem, partly because the problem is a very troubling one to have to see. I'm reaching for an analogy there.

But, obviously, in this case, I can see why you would have trouble tidying up your policy errors on the supervision regulatory side with your intervention capabilities. And when you say there are cases on the record where the Fed, in fact, has gone in and propped up illiquid and insolvent banks, to the extent that that's accurate, that would be an illustration of just what we're talking about, wouldn't it be?

Mr. BRUMBAUGH. Yes, it would.

The CHAIRMAN. Where has that happened, in your view?

Mr. BRUMBAUGH. It happened in the S&L crisis when the Fed lent to the savings and loans which were certainly insolvent, in a market value sense, for example.

The CHAIRMAN. Did that happen in any significant number of cases, to your knowledge?

Mr. BRUMBAUGH. I've never studied the issue to the extent of which it happened.

The CHAIRMAN. But you know of at least how many? One, two, three, four?

Mr. BRUMBAUGH. Senator, I don't know.

The CHAIRMAN. Do you know of any cases with commercial banks?

Mr. BRUMBAUGH. No, it's not an issue that I studied in depth.

The CHAIRMAN. Does anybody else know of any examples with commercial banks that the Fed might have done that?

Do you, Mr. Barth? I know there's a suspicion in a couple of cases. Have you looked at that?

Mr. BARTH. It's sometimes difficult to get information from Federal bank regulatory agencies, as you well know. I recall having that conversation once before here. I do not know of any situations.

You are probably aware of the shared lending program in the S&L industry. I think that's what Dr. Brumbaugh was referring to.

The CHAIRMAN. Dr. Reinicke, do you know of any cases?

Mr. REINICKE. I don't know of those particular cases where there was a conflict, but it can be shown, historically, that there have been conflicts between adjusting the American banking system to international competition and the Fed's fear of having its monetary independence jeopardized. The Comptroller and the FDIC have long been advocating the repeal of Glass-Steagall, supported by industry and supported by the experts.

On several occasions, in the early to mid-1980's, the Fed feared that, as a result of advocating and implementing certain regulations, its independence would be questioned and this question was actually linked to this Committee and on the House side, to a question of its independence.

Mr. BRUMBAUGH. One can just imagine how the Fed is going to respond to this. The Fed's going to say it never happened. So it's important to put it into the appropriate context to understand why it doesn't happen very often, if it does happen.

That's the following reason: Widespread runs don't occur in our system because, at the moment, we have Federal deposit insurance. The main bulwark against runs against federally-insured depositories is the fact that most depositors are aware that their funds are insured by the Federal Government now, explicitly, with the full faith and power of the Federal Government. Therefore, that stops runs, that stops widespread runs against institutions, so it doesn't happen very often, in the first place.

Mr. REINICKE. Could I just add something to this? The broader discussion that we're having here also goes back to one of the principal arguments about checks and balances.

Separating those three functions creates, what I would consider, a true system of checks and balances. In many ways the Fed actually will have influence on regulatory policymaking precisely be-

cause the regulator is afraid that imprudence in regulation will be exposed by the insurer and lender of last resort.

So, indeed, we're actually moving to what would come close to a true system of checks and balances. Each of the three agencies will influence the regulatory process from their perspective.

The CHAIRMAN. Ms. Jarvis, this has been a very good discussion, and I appreciate all of you engaging in it, but in your testimony, you vividly described some of your experiences in attempting to discern, in your words, "who was at the wheel of the Federal regulatory ship."

I'm particularly disturbed to hear what you've described, and again, I use your words, as a "lack of a clear and cohesive response from Federal regulators" in the area of consumer protections, for example, and the fact that you've had difficulties in receiving a unified response on consumer issues and issues of mortgage discrimination.

These are fundamental violations of law because we've written provisions into the law to prevent that from happening. How then do you deal with these consumer complaints?

Wouldn't that be one of the most compelling reasons to have this consolidation, so we've got a point of authority and responsibility where you don't get this run around, this Catch 22, where you call here and they say, no, that's not us, call there, and the next thing you know you're put on a hold button forever. Isn't that one of the things we gain here?

Ms. JARVIS. I think it's one of the most important things, Mr. Chairman. I think the question of accountability is one of the most important reasons for the consolidation. A consumer ought to be able to call a single place, a single 1–800 number and get an answer to complaints, and find out, immediately, how to resolve those complaints. That does not now exist.

Ironically, one of the Federal regulators or representatives was at our hearing recently, when we raised the issue of appraisers not knowing the areas well. She indicated a personal experience where she had gone to a bank to get a loan in her neighborhood. This was a person who was a representative of the Federal agency who, herself, conveyed a concern about the fact that she had gone to get a loan for her home and was told by the lender that they didn't lend in that area because they did not have appraisers who knew the area.

She was, herself, a representative of one of the Federal regulators. Clearly, citizens who have less knowledge of the system than one who represents the banking interests ought to have a place to go to resolve that kind of thing.

That really is at the basis of some of the discrimination in lending that goes on now. And that is that appraisers are not hired who know multiethnic neighborhoods, for example, and have a capacity to evaluate them.

So the accountability that comes as a result of having a streamlined system with regulators in the same system is, I think, one of the most important consumer protections that can be the result of this consolidation.

The CHAIRMAN. It's been my experience, that of the bank regulatory agencies, the Fed has perhaps been the slowest on the consumer protection side.

I'm not talking about something that's ephemeral. I'm talking about getting at persistent patterns that violate the law and any sense of equity in our system.

It doesn't mean they don't care about it; they just seem to be slower to get at it and there's more haggling among the regulators to try to get effective devices for dealing with these problems. More often than not, it's been my observation that the Fed is the last one. That's troubling to me as well.

I don't quite understand why. It shouldn't be that way and it's no badge of honor for the Fed that they distinguish themselves from the other regulators in that fashion.

I want to try to get that problem solved too, if we can. We can't necessarily do that just in discussion of this legislation now, but in its own way it relates to it.

Let me thank you all for your testimony.

Mr. SCHATZ. Can I add just one thing? I would have liked the opportunity when Senator Shelby was here, but there was such expert comment from over on the other side, I held off.

But, from a general perception, the Senator mentioned the fact that people have great faith in the Fed. If you ask the average citizen, what does the Fed do, they fight inflation. I don't think people really have any idea that there are 3,300 regulators out there that are working on the same kinds of things that three other agencies in the Federal Government are. Honestly, that was my perception.

I don't pretend to be an expert in banking, but we're working on recommendations that came out of people that studied this problem for many years.

I don't think that you diminish the respectability of the Fed, the role of the Fed, or anything regarding what they are really out there to do, if you incorporate all the changes in your bill. I think that's what you should do.

The CHAIRMAN. Thank you.

I think that small army of bureaucracy that's out there, that 3,300, is under the radar screen. They got off the radar screen because they're out in the field. Looking at a sensible consolidation scheme and allowing some downsizing of bureaucracy, which is what's going on in the private sector and in the Government, this is an area that needs to be subjected to the same rational forces of discipline and commonsense that applies to other areas of Government.

What I think happened here is these other issues have been thrown up as a smoke screen when, in fact, handling monetary policy, fighting inflation, overseeing the efficient use of the payment system, and the ability to deal with systemic risks, are all adequately handled without the army of the 3,300 out across the country.

In fact, they might be able to do their central functions much better if they took another 100 or 200 of the 3,300 and brought them back to the central bank and put them to work on these other functions, and allowed the bank supervisory process to get its work done. We might come out ahead on both counts that way.

Mr. SCHATZ. I would agree with that, Mr. Chairman.

The CHAIRMAN. Thank you all again. You've been very helpful. The Committee stands in recess.

[Whereupon, at 12:10 p.m., Friday, March 4, 1994, the Committee was adjourned, subject to the call of the Chair.]

[Prepared statements of witnesses follow:]

United States General Accounting Office

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BANK REGULATION

Consolidation of the Regulatory Agencies

Statement of Charles A. Bowsher
Comptroller General of the United States

GAO/T-GGD-94-106

Mr. Chairman and Members of the Committee: I am pleased to be here to discuss legislation to consolidate the activities of the four Federal agencies responsible for the regulation and supervision of more than 13,000 banks and thrifts. These institutions, together with their holding companies and the 600 U.S. branches and agencies of foreign banks that would also be affected, hold more than $5.5 trillion in assets.

I welcome the Committee's interest in simplifying the regulatory structure, and I would like to commend you for taking on this longstanding and difficult issue. Over a year ago, as part of testimony[1] that covered a number of banking and thrift issues, I suggested that there were opportunities along these lines that should be considered.

Several proposals have been made recently for consolidating the regulatory activities of the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC). Some of these proposals would place all of these activities in a single independent regulatory agency, the Federal Banking Commission, while other proposals would retain more than one regulator. The relative strengths and weaknesses of each major approach need to be carefully debated, and I hope that my remarks will be helpful.

We support the objective of reducing the current number of Federal banking regulators. However, until the questions about the role of the Federal Reserve in bank supervision can be resolved, we think a logical step would be to combine OTS, OCC, and FDIC's supervisory responsibilities for State-chartered banks that are not members of the Federal Reserve System into one independent agency.

Current Structure Limits Effective Regulatory Performance

Over the past several years, our studies of the banking system have included failed institutions, agency approaches to examination and supervision, regulatory burden, and implementation of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Although we did not study the efficiency and effectiveness of the regulatory structure as a whole, our work provides a picture of the difficulties inherent in four agencies regulating banks and thrifts. For example:

- In our February 1993 report[2] on safety and soundness examinations, we found that these examinations were too limited to fully determine bank and thrift safety and soundness. The key weaknesses included lack of comprehensive internal control assessments and insufficient review of loan quality and loan loss reserves. A lack of minimum, mandatory examination standards in these areas was a common factor among the regulatory agencies; this deficiency limited the reliability of the examination process. We also identified significant inconsistencies in examination policies and practices, including differences in examination scope, frequency, documentation, and assessment of critical areas, such as loan loss reserves. Such inconsistencies could result in disparate conclusions regarding the safety and soundness of an institution, depending on which regulator does the assessment.
- Differences among the regulatory agencies in the priority they give to, as well as the examination approaches they take in, enforcing consumer protection and community lending legislation have contributed to concerns about effectiveness and inconsistency in these areas. Similarly, in our examination of regulatory impediments to small business lending we also found that the agencies gave conflicting advice to their institutions about the procedures for taking real estate as collateral to support traditional small business working capital and equipment loans.[3]
- Overlapping authority is a particularly significant problem in bank holding company regulation. Holding companies, which are all regulated by the Federal Reserve, now control 94 percent of the banking assets in this country. Except for about 970 State-chartered banks that are members of the Federal Reserve System, at least two Federal regulators must oversee the activities of each bank and its transactions with its affiliates. Although the regulators try to coordinate their supervision and examination functions, this effort is not always successful and questions of accountability arise. The failed Bank of New England is such a case. OCC was responsible for examining the lead bank, but the Federal Reserve was responsible for approving expansion proposals and for the holding company examinations. In this case, an early warning of problems and timely corrective action

[1] *Banks and Thrifts: Safety and Soundness Reforms Need To Be Maintained* (GAO/T–GGD–93–3, January 27, 1993).

[2] *Bank and Thrift Regulation: Improvements Needed in Examination Quality and Regulatory Structure* (GAO/AFMD–93–15, February 16, 1993).

[3] *Bank Regulation: Regulatory Impediments to Small Business Lending Should Be Removed* (GAO/GGD–93–121, September 7, 1993).

did not occur. This bank failure alone cost the bank insurance fund about $1 billion.[4]

- The current practice of trying to reduce inconsistency by having all the regulatory agencies adopt a common rule has resulted in cumbersome interagency rule making procedures. Although regulations are ultimately produced by this process, it is inherently inefficient and can result in delays and missed deadlines. Implementation of FDICIA is such a case. Numerous staff from each of the regulatory agencies were involved over an extended period. However, despite this effort, the statutory deadline for the noncapital tripwire provision (section 132 of the Act) was missed.

Improved Regulatory Practices Should Accompany Any Restructuring

Reducing the number of regulatory agencies would help solve some of the problems I have described. However, I think it is clear that efforts to improve the effectiveness and efficiency of bank regulation also should address how the agencies do their work. The need to link consolidation with improving the effectiveness of regulation is particularly important for ensuring implementation of the reforms that were contained in FDICIA.

In today's competitive markets, banks and thrifts must be well capitalized and have good internal controls to operate safely and to protect the funds of their customers and also the funds of the deposit insurance system. FDICIA contributes to accomplishing this goal in several ways. Through what is known as its prompt corrective action provision, the act creates a powerful incentive for depository institutions to operate prudently because the regulators are required to close down any bank before its capital is exhausted.

In addition, FDICIA requires that a depository institution's management, external auditor, and regulator all focus on the adequacy of the systems that are used to manage risk and that determine the bank's financial condition. Further, as previously stated, in our reports, the regulators were not comprehensively reviewing internal controls and control weaknesses contributed significantly to the failure of banks and thrifts. Under FDICIA, managers of the larger banks and thrifts must annually assess and report on the effectiveness of internal controls, and the institutions' external auditors must review and report on management's assertions. Thus, FDICIA should also reduce regulatory burden by eliminating redundancy if Federal and State regulators seize the opportunity for improved coordination with, and reliance on, external auditors.

I cannot emphasize enough the importance of successfully implementing these reforms. Not only are they necessary in the present regulatory structure, but they are equally essential to ensuring that any form of consolidation will achieve its goals. When properly implemented, these reforms will produce better information about the financial condition of insured institutions and this better information, should result in fewer surprises from the failure of large banks and thrifts. These reforms are thus essential for reducing the potential risk in consolidating agencies or modifying the supervisory duties of FDIC and the Federal Reserve, the agencies that bear responsibility for deposit insurance and financial market stability, respectively.

Managing the Deposit Insurance Function

The Administration's proposal would leave intact FDIC's responsibility for managing the deposit insurance system, including setting risk-based premiums and resolving problem cases. We are on record as favoring a strong, independent deposit insurance function to protect the taxpayers' interest in insuring more than $2.5 trillion in deposits. Although access to the information of other agencies is important, we believe FDIC needs to have the authority to go into any problem institution on its own, without having to obtain prior approval from another regulatory agency. FDIC also needs the capability to assess the quality of bank and thrift examinations generally, and it also needs backup enforcement power. However, as I suggested previously, when the prompt corrective action and related provisions of FDICIA are operating effectively, we would hope that the number of instances in which FDIC will need to conduct independent examinations to protect the insurance funds will be relatively infrequent.

The Role of the Central Bank

Under the Administration's approach, the Federal Reserve would retain its responsibilities for monetary policy, the payments system, and the discount window. Federal Reserve officials say that their ability to perform these functions would be

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[4] *Bank Supervision: OCC's Supervision of the Bank of New England Was Not Timely or Forceful* (GAO/GGD-91-128, Sept. 16, 1991).

seriously impaired, particularly in times of financial stress, if the Federal Reserve lost its responsibilities for regulating and supervising bank holding companies and State member banks. Because benefits from consolidation should not come at the cost of risking damage to the financial system or from limiting the independence of monetary policy, the Federal Reserve's concerns warrant serious consideration.

Experience suggests that in times of financial stress, such as the 1987 stock market crash, the Federal Reserve needs to work closely with the Department of the Treasury and others to maintain market stability. The Federal Reserve asserts that its effectiveness in such situations is enhanced by its detailed knowledge of, and influence on, the operations of institutions and markets both in this country and abroad. The extent to which the Federal Reserve needs to be a direct supervisor of financial institutions to obtain the requisite knowledge and influence for carrying out its role is an important question. Until this question is answered, it could be risky to eliminate the Federal Reserve's direct involvement in bank supervision in view of the complexity of the international environment in which major banks operate.

Although no other country has a banking system exactly like ours, we think that some insights can be gained from the way other countries have set up their regulatory systems. For example, Germany has a separate agency that has the legal regulatory authority over banks; this agency is responsible to the Ministry of Finance. Nevertheless, it is required by law to consult with the central bank before issuing regulations, and the central bank can veto regulations affecting bank capital and liquidity.

Furthermore, the regulatory agency shares supervision responsibilities with the central bank. While actual on-site examinations, for the most part, are conducted by external auditors, the auditors' reports are filed concurrently with the central bank and the regulatory agency. Additionally, individual institutions file daily, weekly, and monthly reports with the central bank. The central bank, in turn, analyzes these reports and provides summaries to the regulatory agency. In addition, the central bank is in frequent contact with banks to discuss questions, issues of interest, or perceived problems.

These arrangements give the central bank a significant role in working with the supervisory agency to identify and deal with both problem situations and issues facing the banking system as a whole. The German case suggests it is possible to work out practical arrangements that enable both central bank and bank supervisory functions to be effectively carried out. The German system also shows, as I previously stated, that effective use of external auditors can reduce regulatory burden.

In summary, many factors should be taken into consideration in determining how best to achieve the independence of monetary policy and the proper implementation of other central bank functions. In the final analysis, these factors involve policy judgments that only Congress can make.

Dual Banking System Adds to Complexity

State-chartered banks are a unique and valuable part of the U.S. financial system, accounting for 69 percent of the banks and 43 percent of bank assets. The major safety and soundness problems with the dual banking system that have concerned us in the past include the adverse impact on the bank insurance funds arising from poor supervision and the ability of State-chartered institutions to engage in risky activities that were not allowed for federally-chartered institutions. These problems have been addressed in recent legislation. Pursuant to provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and FDICIA, FDIC must determine that there is no undue risk to the insurance funds from any State bank activity that is not allowed for a national bank. In addition, all banks, regardless of their charter must be examined either annually or every 18 months, depending on their size and financial condition.

As Congress considers consolidation proposals, we believe it is important to keep in mind that arrangements to preserve a dual banking system should not create new incentives to weaken essential regulation by allowing banks to play one regulator off against the other. One incentive that should be reexamined is the present practice of charging national banks, but not State banks, for Federal examinations.

Alternative Approaches

The Federal Banking Commission proposed by the Administration clearly provides a way to deal with the problems of inefficiency and overlapping authority that I described earlier. However, as I have indicated, that approach is not without its risks. Progress can also be made in other ways.

We support the objective of reducing the current number of Federal banking regulators and in doing so creating an independent regulatory body. However, until the

questions about the role of the Federal Reserve can be resolved, one logical step would be to merge OTS, OCC, and FDIC's primary regulatory responsibilities for State-chartered nonmember banks. Consolidating the primary regulatory functions of these agencies into one independent body should improve the efficiency of rule-making and produce some administrative cost savings.

Further efficiencies could be gained by reducing the current overlapping responsibility for supervision of a holding company and its subsidiaries. Key areas of risk-taking by a holding company are usually centrally managed, and experience shows it is difficult to completely isolate a bank from ties to its holding company. Therefore, if the Federal Reserve maintains its regulatory responsibilities, it would make sense to strive for consolidated supervision of each holding company and all of its subsidiary banks by the lead bank regulator. The details that would need to be worked out include the Federal Reserve's role in (1) supervising large banking companies; (2) rulemaking; (3) approving applications of individual holding companies in areas such as mergers and participation in nonbank activities; and (4) supervising foreign banks, branches, and agencies. Efficiencies from reducing overlapping responsibility at the bank and holding company levels could also be achieved within the present regulatory structure and should be addressed even if a consolidation plan is not implemented.

Implementation and Transition Issues

Even a consolidation approach that is well conceived may not accomplish much if it is not effectively implemented. There are many practical problems associated with creating a new agency or consolidating existing functions. It seems reasonable to expect savings in administrative and operating costs, all of which should reduce industry compliance costs. However, time and time again, in both Government and the private sector, we have seen that consolidation has not automatically created an organization that demonstrates effective efficient operations. Thus, it is important that transition and implementation issues be included when considering consolidation, particularly in view of the need to improve many regulatory practices.

Conclusion

Mr. Chairman, in passing FDICIA this Committee took a major step toward modernization of the banking system. Taking action to simplify the regulatory structure represents another important step. As this step is being contemplated, however, I think it is useful to bear in mind that there are additional opportunities for bringing more effectiveness and simplicity to the regulatory system. Some of these involve the banking industry itself. For example, authorizing interstate branching would simplify the regulatory process by giving institutions the opportunity to simplify their corporate structures.

Other issues, such as regulation of mutual funds and derivatives, require looking beyond the banking industry to the broader financial services marketplace. In the derivatives area, for example, the major players include securities and insurance companies, in addition to banks. We are currently studying this issue and will soon provide Congress with our conclusions and recommendations. However, improvements in the regulatory structure need not be delayed because of these complicated issues.

Mr. Chairman that concludes my prepared statement. My colleagues and I would be pleased to answer questions.

PREPARED STATEMENT OF CHARLENE DREW JARVIS

COUNCILMEMBER, FOURTH WARD OF THE COUNCIL OF THE DISTRICT OF COLUMBIA

Good morning Chairman Riegle and other distinguished Members of the Senate Committee on Banking, Housing, and Urban Affairs. I am Councilmember Charlene Drew Jarvis, a representative from the Fourth Ward of the Council of the District of Columbia. I am pleased to testify before you today on Senate Bill 1633, the "Regulatory Consolidation Act of 1993" introduced by Chairman Riegle and Senator D'Amato.

I am here today to voice my support for S. 1633, the consolidation of bank supervisory functions in a Federal Banking Commission, because I believe that the ultimate result of the consolidation will be an improvement in banking services to individuals and businesses and an increase in confidence in the efficiency and equity of our banking system, generally.

During most of my tenure as a locally elected official, I have had the privilege of serving as the Chairperson of the Committee on Economic Development. The responsibilities of this committee include oversight for the recently established Office

of Banking and Financial Institutions which charters and regulates banks operating within the District. In addition, my committee reviews and approves mergers and acquisitions of banks and bank holding companies in the District following the local superintendent's review and recommendation. Lastly, the committee assists in negotiating and monitoring banks' community development requirements pursuant to DC Law 6–107, the "Regional Interstate Banking Act Amendments Act of 1985," and amendments thereto.

I would like to enter into the record some of the experiences I have had as a local official of a city/State working with Federal bank regulatory systems. I believe that these examples may aid the Committee in understanding how the current regulatory system might be streamlined to better meet the needs of consumers, businesspersons, and banks alike. I understand that certain witnesses have a concern about the bill's impact on the dual banking. While I appreciate those views, I am testifying from the vantage point of a legislator in a jurisdiction with almost all federally-chartered banks.

Experience During the Drafting of the Regional Interstate Bank Compact

Until 1984, my committee's responsibility for banking was almost vestigial. In that year, the District decided to exercise its congressionally conveyed authority, under the Douglas Amendment of the Bank Holding Company Act, to authorize the District to participate in interstate bank mergers. This was the first time that we interacted in any meaningful way with Federal regulators as we sought to become part of the Southeast Compact of 11 States that would allow reciprocal interstate banking. I must mention at the outset that individuals at the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the *then* Federal Home Loan Bank Board were always helpful and courteous in helping us craft this significant legislation. Thus, I would limit my critique today to the current regulatory framework rather than to any individual or individuals within this regulatory system.

It was important to our committee that community development commitments be a part of any merger application into the District. We believed that these commitments would help ensure that out-of-State holding companies would address local needs. It became immediately clear to me, however, that there would be much confusion and overlap in enforcement between several of the Federal bank regulators and between the Federal regulators and the District's Office of Banking as we finalized the community development portion of our legislation. Such confusion could occur because these development requirements were more stringent than Federal Community Reinvestment Act regulations and because at least two Federal regulators would be responsible for reviewing the validity and enforcement of these commitments.

The way I understood the process to work, the Comptroller would have a say because nearly all District banks are federally-chartered. Thus, the Comptroller's compliance examiners and auditors would view the commitments of the holding company's bank subsidiary. In addition, the Federal Reserve would have some level of jurisdiction because of their jurisdiction over the holding company structure. I do not believe that the respective Federal regulatory roles were ever clearly established as to the District's community development requirements.

As I recall, implementing our current banking laws became an exercise in fortitude and a lesson in patience for members of the Committee on Economic Development. Letters and opinions went back and forth between Federal agencies and my committee and we finally arrived at some understanding about how much authority we had with regard to national bank community reinvestment commitments and about which regulators would be reviewing the community development requirements. I believe that this process would have been less elusive if completed within the structure of the proposed Federal Banking Commission.

Experience During the Mergers and Acquisitions Process

My experience with the mergers and acquisitions process in the District is that my committee must comprehend a myriad of Federal and local standards prior to any approval by our legislature. For example, an applicant for a national bank charter with a holding company must apply to the Federal Reserve and speak to issues of the parent company's stock ownership and the overall quality of capital and assets of the parent. The bank subsidiary, however, must apply to the Comptroller of the Currency and speak to issues of the subsidiary's health, branching laws, operations of the bank, and convenience to the community. And the Justice Department and Securities and Exchange Commission have an ancillary role because of issues of antitrust and publicly held stock, respectively.

Having gone through some 11 mergers and acquisitions in the District, I now believe that the current decentralization of regulatory responsibilities can hinder a regulator's ability to accurately view a merger transaction or to understand its full impact.

Additionally, a recent District merger applicant applied, consecutively, to Maryland State regulators, Federal Reserve regulators, the District regulators, and finally to the Comptroller of the Currency. I take the position that these varied applications were, in effect, one related transaction that should have been reviewed by a single regulator. I believe that we are at a disadvantage when each regulator reviews an application according to his or her own regulations, precedent, and standards. The disadvantage occurs because each regulator sees only one part of the merger picture.

I would add that the current regulatory structure invites a degree of forum shopping. This simply means that banks attempt to merge under statutes and regulations that are more beneficial to them. This also means that, with a good attorney, you can find out which regulator has historically been willing to grant the merger that you seek. This situation would be effectively cured under the proposed Federal Banking Commission because standards would be unified.

Experience with Failed District Banks

As the distinguished Committee is aware, several banks located in the District have failed within the last few years. In the wake of the failures I learned that the FDIC's supervisory powers in cases of weak or failing banks were quite omnipotent and overrode other laws and regulations. Bank customers and business persons contacted our office and stated that they did not have an understanding of the FDIC's role in certain instances and that the FDIC seemed not to be concerned with any community commitments that had been heretofore hammered out by the District. Here again, there would be a benefit to the community if the FDIC retained its insurance role, but if the supervisory standards were the duty of a single regulatory body.

I am cognizant that the FDIC was dealing with serious safety and soundness issues but this begs the next question. Why were not the banks' capital and managerial problems dealt with much sooner? Who was at the wheel of the Federal regulatory ship? I believe that a properly constructed consolidation bill would lead to a more efficient warning system to spot banks that are in financial trouble.

I would also state that the plethora of failed banks nationwide during the last several years led to overregulation of banks by Federal regulators. Within a period of less than 10 years, Federal regulation swung wildly between de-regulation and overregulation of financial institutions. This erratic regulatory structure does not aid in creating a stable and growing economy. I would hope that by streamlining the regulatory structure, the standards for banks would be consistent and not capricious.

Experience with Local Business and Homeowner Complaints

As an urban area with a large minority population, the District, like many similar cities, has problems with residents receiving equal access to capital from financial institutions. Unfortunately, this problem is compounded by the lack of a clear and cohesive response from Federal regulators. During a recent hearing which I held at Union Temple Baptist Church in the southeast quadrant of the District where many of the germane Federal regulators were present, my committee could not get a unified response on the following issues:

(1) Who has the ultimate authority over individual complaints of mortgage discrimination based upon race or other statutorily-protected classes;

(2) Has the hiring of minority appraisers been statutorily addressed with regard to the Resolution Trust Corporation in the FIRREA law;

(3) Why are certain banks receiving excellent or satisfactory CRA grades when their depositors feel that they do not adequately serve their communities.

Under the proposed Federal Banking Commission, the community would have some guidance as to where banking complaints could be quickly and equitably handled because one agency would be responsible in this area.

In summary, my experiences as a local legislator have shown me that our current financial regulatory system is in need of more consolidation and less duplication. The Riegle/D'Amato bill, if enacted, will start us down a streamlined regulatory path.

Conclusion

This concludes my formal testimony before the Senate Banking Committee. I want to thank the Committee and the Committee staff for permitting me to address

this important and prescient issue. I look forward to answering any questions from Chairman Riegle or the other distinguished Members of the Committee.

PREPARED STATEMENT OF THOMAS A. SCHATZ

President of Citizens Against Government Waste

Mr. Chairman, thank you for the opportunity to testify today on the Administration's proposal regarding regulatory consolidation and your and Senator D'Amato's proposed regulatory consolidation bill, S. 1633. My name is Tom Schatz and I represent the 600,000 members of the Citizens Against Government Waste (CAGW). CAGW was created 10 years ago after the Grace Commission (formally known as the President's Private Sector Survey on Cost Control) published its findings and recommendations to make Government work better.

Since 1986, CAGW has helped save taxpayers more than $250 billion, with another $76 billion in savings over the next 5 years. Many of our waste-cutting recommendations have been adopted by Members of Congress seeking to make the Government more efficient. With the Vice President's National Performance Review last fall, the Clinton Administration also recognized the importance of providing a better return on the investment of hundreds of billions of our tax dollars.

The Council for Citizens Against Government Waste, our lobbying group, joined the quest for regulatory consolidation in late January when our founder, J. Peter Grace, sent a letter supporting the Administration's efforts to Treasury Secretary Lloyd Bentsen. Mr. Grace reiterated his 1984 conclusions that, "The Grace Commission found the financial regulatory system, with its fragmented approach to regulation, inadequate to meet the demands of a rapidly changing industry."

Mr. Chairman, you, and Senator D'Amato deserve the thanks of the American people for focusing attention on the need for consolidation of the Federal Government's banking regulatory system. This is simply a good Government issue, and one that this Committee should move ahead on quickly.

Your Committee has documented more than 50 years of reports recommending consolidation of the bank regulatory system. There is unanimous agreement among experts from both Republican and Democratic Administrations that the current system is archaic, inefficient, and costly, and that consolidation would benefit consumers and improve the safety and soundness of the financial services industry.

Taxpayers are demanding action now to eliminate Government waste. There is nothing more frustrating for them, especially as they approach paying their taxes on April 15, than knowing that there's a good and logical idea in Washington that is being thwarted by some special interest, or even worse, infighting among Federal agencies. Your hearings will help make taxpayers aware of:

- the massive regulatory overlap among the four Federal banking agencies, resulting in duplicative expertise, examinations, applications, State regulatory functions; foreign bank regulation, supervision of U.S. branches and agencies of foreign banks;
- inefficiencies in examinations; regulation of State-chartered institutions and bank holding companies; consumer protection, securities regulation, recordkeeping systems; and even simple items like the timing of applications and notices or defining what constitutes effective filing, withdrawals, or amendments; and,
- redundancy in administrative authority under Federal banking laws, which has resulted in inconsistent interpretations of almost 20 separate Federal statutes.

While this is enough to outrage taxpayers, the biggest waste of all is that nothing has been done. It is time to step beyond differences of opinion and act constructively. One regulator is clearly better than four: Two regulators would still incorporate wasteful duplication—and would also be more likely to engage in a civil war that would result in continued gridlock. This kind of inside-the-beltway turf battle has led record numbers of taxpayers to lose faith in the ability of Government to make effective use of their hard-earned tax dollars.

Mr. Chairman, while the Committee is aware of the recommendations of the Grace Commission's Task Force on Board and Commissions for Banking, I would like to provide a few details. The Grace Commission advised that, "Significant economies are available by consolidating the three closely related regulatory agencies dealing with the banking industry"—the Office of Comptroller of the Currency (OCC), the Federal Deposit Insurance Corp. (FDIC), and the Federal Reserve—into a new Federal Banking Commission. The Grace Commission estimated that this consolidation would save taxpayers $99 million over 3 years following full implementation.

The Task Force staff met with representatives of the Federal Reserve, FDIC, Federal Savings and Loan Insurance Corporation (now the Resolution Trust Corporation), the Federal Home Loan Bank Board, and the National Credit Union Administration. The staff reviewed agency budgets and organizational charts to estimate the 3-year savings.

The individuals interviewed by the Grace Commission staff, both regulators and industry, all asked one fundamental question: "How can the Federal banking agencies ensure safety and soundness and the viability of the Nation's financial system, while encouraging innovation and market-driven growth in the industry?"

Competitors in the marketplace found themselves under the jurisdiction of agencies with different regulatory missions and procedures. The need for change in the regulatory scheme, which had been developed in piecemeal fashion in response to sometimes unrelated needs, was clear. It continues to be imperative for another reason: Banks and thrifts have found ways to break out of the traditional markets before the regulatory system recognized their new products. With the recent approval of interstate banking, the Senate is recognizing these new marketplace realities. It's now time for the rest of the regulatory system to catch up to the outside world.

The Grace Commission focused on the efficiency and cost considerations of consolidating the regulatory agencies and found uneven and irregular treatment of financial institutions. The Commission called five agencies providing essentially the same services "excessive."

The Commission's report cited the cost of regulation, estimated at that time to be $292 million, including a total of 4,880 field examiners and overlapping field offices. With efforts to eliminate duplicative automated data processing and to reduce the need for on-site examinations, the Commission saw even more opportunity for consolidation. Today the Government spends an estimated $1 billion a year on regulators—more than 3 times higher than in 1984—and employs over 12,000 examiners and support staff. This massive growth makes consolidation even more important.

In its conclusion, the Grace Commission report said, "The benefits in efficiency, uniformity, flexibility, consistency, and cost savings indicate that such a consolidation of the bank regulatory agencies into one is both necessary and appropriate."

Under the Grace proposal, the Federal Home Loan Bank Board and National Credit Union Administration would remain intact, but "should be considered for merger into a common financial services regulatory agency as their member institutions become more homogeneous in their products and services with banks."

Your legislation, S. 1633, as well as the Administration's proposal, would form a single regulatory agency out of the four Federal regulators for depository institutions. These agencies include the OCC, the Office of Thrift Supervision (OTS), the FDIC, and the Federal Reserve Board. As proposed by the Grace Commission, Mr. Chairman, this new entity would be called the Federal Banking Commission.

With a hodgepodge of regulations and regulators, taxpayers are funding a bloated and inefficient bureaucracy. The existing system—created with little rhyme or reason—reflects a period of time when commercial banks, savings banks, and thrifts operated largely in their own markets. Government now stands in the way of modern banking practices.

Last November, Secretary Bentsen reported that regulators from different agencies were examining a small bank in California. The examiners outnumbered the bank's employees, and their cars filled the parking lot so customers could not park to do business. The bank regulatory system is out of control and needs to be fixed.

Mr. Chairman, we don't need any more commissions or legislation in the future. Voters want change in Washington now. Eliminating duplication in the banking regulatory system is just what they have in mind.

Vice President Gore recently stated that, "Bank regulatory consolidation is in keeping with both the substance and spirit of Reinventing Government." He called it "a major step forward in the Clinton Administration's efforts to create a Government that works better and costs less."

To quote a well-known television commercial, "just do it."

PREPARED STATEMENT OF WOLFGANG H. REINICKE

RESEARCH ASSOCIATE, THE BROOKINGS INSTITUTION

Mr. Chairman, Senator D'Amato, distinguished Members of the Committee, my name is Wolfgang Reinicke. I am a Research Associate at the Brookings Institution. It is a privilege for me to testify before this Committee on the reform of the bank regulatory structure in the United States. My views are based on independent re-

search regarding the U.S. financial system. I do not attempt to represent the position of any institution or political organization.

It has been almost 3 years since I testified before this Committee on the very same topic and I am delighted that you and the Committee have decided to return to this issue. Given the Administration's renewed initiative to consolidate the Federal bank regulatory structure and the bipartisan support this policy proposal enjoys, I am hopeful that these hearings will contribute to an expedited reform effort of the current structure of Federal bank regulation in the United States that accommodates the interests of all those involved in the debate and serves the public interest.

Before I address what I believe are some of the misperceptions and inconsistencies of those who oppose a consolidation of the Federal bank regulatory structure, let me briefly reiterate why it is in the interest of the U.S. banking system, its institutions and the public as well to proceed with reform. My analysis is based on a close study of the way in which the U.S. banking system has responded to the changing conditions in the domestic and international financial marketplace.

The Changing Nature of Financial Intermediation in the United States

Until the late 1970's, the U.S. commercial banking system consisted of a series of highly segmented, well-protected markets. The instruments of protection were price, geographic, and product regulation. This type of regulatory structure, which created a set of well-defined, functionally different institutions, had its roots in the 19th Century and is often described as a cartel. This cartel began to collapse during the 1970's and in particular the 1980's when the various mechanisms of protection crumbled. As a result, the U.S. commercial banking system has experienced a dramatic transformation. Beginning in the late 1970's, financial and nonfinancial institutions began to invade each others' turf through product innovation, deregulation or loopholes in the current regulatory system subject to administrative rulings and subsequent judicial consent.

Today's financial marketplace is characterized by a multitude of financial and nonfinancial institutions which carry different names, even though they provide the same services. For example, as of 1990 commercial banks have consistently issued more home mortgages than the savings and loan industry, and home mortgage companies have almost doubled their share from 30 percent to 53 percent. The outcome is a highly competitive domestic market environment which has only been intensified by foreign competition and securitization. This increasingly competitive environment has led to a process of consolidation among financial institutions, due to mergers and acquisitions, and/or institutional closure or failure. It is probably correct to assume that the consolidation is likely to continue at an even faster rate in the future as commercial banks continue to circumvent continued geographic and product restrictions in an effort to maintain their market share, or at least slow down their decline, or as Congress reconsiders some of these outstanding impediments in support of a fully integrated, multiproduct national banking system.

The Role of Public Policy

The principal purpose of public policy should be to guide and stabilize this dramatic change at home and abroad, ensure the competitive position of U.S. commercial banks in the domestic and global marketplace and minimize the associated social and economic costs. As such, regulation should promote a financial system that has internalized the underlying changes in the market structure—domestic and international—while providing for adequate soundness and stability of the banking system, the individual institution and most importantly the protection and safety for the consumer.

The projection of private sector interest, in particular during these times of rapid change and adjustment, into the realm of public policy is nothing new, nor is it unique to the United States. All democracies—albeit to different degrees—are characterized by a continued, sometimes conflictual dialogue over the role of public policy in a market economy. But when regulators in the United States attempted to stabilize the process of change and consolidation in the financial marketplace in order to minimize the social and economic costs associated with it, their experience tells us that they are often caught in the multilayered, decentralized structure of their own regulatory system.

More specifically, the existence of multiple regulatory agencies in the U.S. financial system creates institutional overlap among the regulators at the Federal level, leading to the emergence of different regulatory regimes. This forces regulators to compete with each other in a market for regulation, reversing the traditional role of public policy. Rather than being a complement to the financial markets by providing the general framework within which financial institutions can compete freely

and fairly, financial regulation is developing into a market itself and thus becomes an endogenous factor in the decisionmaking process of private sector institutions. As one industry representative recently stated, "If the Comptroller is giving me a hard time, it's nice to know that I can go to the State bank department and they will welcome me with open arms." If the purpose of public policy is to evade it, we need no public policy at all, and I would include in that the regulation and supervision of our banking system.

But this cannot and should not be the proper role of public policy. Clearly private sector input into the *formulation* of policy is one important ingredient. But financial market regulation and supervision should not be the reflection of competing private sector interests nor should it be the result of competing regulatory regimes in a single integrated market. *Public policy should not be the consequence of competition, it should be the cause for competition in the financial marketplace.*

The regulatory overlap and competition among regulators has increased sharply in recent years as a result of the continued functional integration of financial markets and the continued pressure for institutional consolidation. This has heightened the conflict in the public sector domain, especially among regulators. Functional integration has prompted jurisdictional turf battles among regulators, and the pressure for market consolidation has prompted a struggle for institutional legitimacy as regulators fear a declining number of institutions they can regulate and supervise. Together, jurisdictional turf battles and the struggle for institutional legitimacy have led to a new, separate set of policy incentives on behalf of regulators, in addition to the long-term mandate to ensure financial soundness of individual institutions as well as systemic stability.

Let me elaborate on this second set of policy incentives. Institutional survival of regulators, under conditions of functional integration and market consolidation, produces policy incentives that for the most part are short-term as they react to market developments. To be more specific, to maintain their status and clientele, individual regulatory agencies cannot just contemplate the interests of the financial system as a whole, but must at all costs embrace the preferences of that very individual segment of the financial industry they regulate. Unless they can defend or even enlarge the market share of their constituency, and thereby their own regulatory turf, they will not be able to endure over time.

Unfortunately, these two sets of incentives—the long-term mandate of institutional soundness and financial system stability, and the short-term interests to ensure institutional survival—are not always compatible and more often conflict. In fact, they have produced the following policy pattern. Short of a major financial crisis in which the long-term public policy mandate outweighs the particularistic interests of the regulatory agencies, the short-term incentives continually dominate the policymaking process of financial market regulation in the United States, as witnessed during the last decade. And it is this predominance of a short-term set of interests that not only explains the perpetual conflict, but also the ad hoc and reactive nature of financial regulation, whereby individual regulators constantly try to respond either to the short-term pressures of the marketplace or to a regulatory adjustment by a competing regulator.

One striking example of the reactive nature of public policy in the domain of U.S. financial markets is the fact that in much of the literature on financial regulation in the United States, it has become almost a conventional wisdom that Government regulatory forces will always lag behind the market forces and there is nothing that policymakers—regulators and the legislature alike—can do about it but accept it. And clearly the experience of financial regulatory policy during the last decade attests to this phenomenon. But I think that one should not jump too fast to such a conclusion and it would be dangerous for policymakers to accept this argument. Given the dynamic that I outlined above, I would argue that the predominance of market forces in determining regulation merely reflects the predominance of the short-term incentive structure on behalf of regulators. This, however, does not *a priori* rule out a proactive, preventive, and thus anticipatory public policy legislated by U.S. policymakers.

As I have just explained, the current incentive structure generates policy outcomes that by definition must lag behind and be *reactive* as they respond to market dynamics. Thus, as long as the conflict between the short-term institutional interests and the long-term policy mandate has not been resolved I would not want to accept the deterministic arguments, so prevalent in the literature on financial regulation, which characterize market forces as wholly insurmountable.

In fact, the example of other nations' financial systems, as well as developments in international financial markets, suggests that public policy can indeed be *proactive* and anticipatory. Moreover, I would be inclined to argue that unless the long-term mandate of financial regulation clearly outweighs the short-term institu-

tional interests of individual regulatory agencies, it would be less costly in social, economic, and even political terms to have no regulation at all. *Focusing on the long-term health and stability of the financial system supports the dictum that prevention is better than the cure.* It is also less costly, as has been so aptly demonstrated by the experience of the Savings and Loan debacle.

As you can tell from the above analysis, I consider the decentralized, multilayered and overlapping structure of financial regulation in the United States as one important, though not the only, reason for the problems the U.S. banking system has experienced during the last decade.

I do not need to elaborate on S. 1633 and the Treasury's reform proposal. Let me say, however, that in addition to dealing with what has been described by all parties involved in the debate as a costly, burdensome, inefficient, and archaic system, it also addresses the broader public policy concerns that I have outlined above and equips the U.S. banking community with a regulatory structure that can meet the challenges ahead. A single independent Federal Banking Commission, which includes among its members representatives from both the Treasury and the Federal Reserve as well as the financial community, consolidates and concentrates the experience and expertise that both institutions have, ensures continued diversity of opinion, and meets their legitimate interest in participating in the broader long-term policymaking process that determines the future structure of the U.S. banking system. At the same time it relieves policymakers from the constant short-term challenge to respond to the pressure emanating from both functional and institutional consolidation that I have described above. As a result, regulators can address the underlying structural problems and future challenges of the U.S. banking system and create framework conditions that ensure its health and international competitiveness.

Responding to Critics

Let me then turn to several of the critiques that have been advanced against the reform proposals. One of the most frequent criticisms states that reform would create an all too powerful superagency, eliminating all the necessary checks and balances that were so carefully crafted during the first three decades of this century. Such criticism is unfounded and must be rejected.

First, Congress can deal directly with any problems of excessive power without recourse to several regulatory agencies. Second, and more important, an analogy of the fragmented regulatory system and the constitutional principle of separation of powers is false because the three regulatory agencies perform the same functions. One agency does not check or veto the actions of another. It *cannot,* and the history of administrative rulings over the Glass-Steagall Act attests to that.

Third, the composition of the commission as envisioned in S. 1633 ensures the presence of several viewpoints on questions of regulatory policies and supervisory practices. Fourth, the bulk of policymaking with respect to the U.S. banking system should be conducted by the three branches of Government which continue to guarantee the presence of checks and balances. Given that S. 1633 is a co-sponsored bill and has the support of the Administration it has already met a considerable part of that test and will continue to do so in the future. If anything, S. 1633 would make regulators more accountable to Congress and the public. To quote Senator Proxmire, former chairman of this Committee, "I think it's far easier for this Committee, which has oversight on all of these agencies, to act if we have a single agency on which to concentrate rather than if we have three disparate agencies with different people to be confirmed who are each doing things at different times in different ways. So our oversight would be improved, too."

Another and related criticism is that the proposed Commission is a "monolith," a "monopoly bank regulatory agency," that this is at great cost to the broader efficiency and flexibility of our financial system. First, as to efficiency, the fact that a single commission is more efficient by consolidating bureaucratic waste and overlap and reducing costly and repetitive examinations has been demonstrated and need not be repeated here. Second, first and foremost *markets* should be efficient and flexible. To put that burden on regulators misses the point and defies their purpose. Third, *regulatory quality not quantity counts* in determining the flexibility and global competitiveness of our financial system. In other words, not the number of regulatory agencies but the nature of actual regulations and the manner in which they are implemented is important. In fact, when it comes to actual regulatory policy the presence of multiple regulatory agencies would not make any difference. All agree that the time has come to revise the current structure of geographic and product regulation. Fourth, it is surprising that the Federal Reserve would join those that have suggested that the independent Federal Banking Commission would turn into a monolith and exercise monopoly power. Not only has the Federal Reserve, with

broad support from all branches of Government, long been an advocate of its own independence in order to conduct monetary policy, but the thought of having that independence compromised by a parallel body equally entitled to determine interest rates or operate a discount window among which banks could choose seems not just utterly unrealistic; it would defeat the very purpose of sometimes difficult and even controversial decisions and remove the Fed's accountability as the single institution responsible for the conduct of monetary policy. If monopolies in the domain of policymaking are so inefficient, then why, and in my view appropriately so, do we have a single agency responsible for the conduct of monetary policy?

Critics have also argued that a single regulator charged with responsibilities for safety and soundness is likely to have a tendency to suppress risk-taking. If anything, the evidence from the debacle in the Savings & Loan industry, which was regulated, supervised, and insured by a single agency (the Federal Home Loan Bank Board), points in the opposite direction.

It has also been argued that history suggests that competition among regulators has tended to moderate incentives to be lax in supervision. The history of the Glass-Steagall Act during the last 20 years suggests the opposite. In fact, as early as the 1960's then Comptroller of the Currency James Saxon unilaterally allowed commercial banks to enter the securities business, against the will of the Federal Reserve and the FDIC. At the time he could only be stopped by the courts. However, since the early 1980's the Glass-Steagall Act has been dismantled through slow, costly, and arbitrary administrative actions of one individual regulator, often against the fierce opposition of the others. I don't mean to imply that Glass-Steagall should not be repealed. To the contrary, given the reality of the U.S. financial marketplace such a move by Congress is long overdue. *But the fact that many have argued that it has been repealed "de facto" but not "de jure" not only raises questions about the apparent ability of the present structure to ensure checks and balances but also about the process of regulatory policymaking itself.*

Another argument that has been made is that under the reformed regulatory structure banks would be less able to take on international competition. No evidence for that is available, however, if anything it points in the opposite direction. Germany and Japan have one single regulator that cooperates closely with the central bank. But again, it is not the structure of regulation that is the most important element in determining international competitiveness but the regulations themselves and, equally important, the management, skill and strategic choices of the banks themselves.

However, I do believe that the United States should be represented by both the Federal Banking Commission and the Federal Reserve in the deliberations on global regulatory issues. This would best be achieved if the representative from the Fed on the Commission would participate in the discussions that, for example, take place in the Basle Committee or any other institutional setting that may evolve in the future.

Critics of reform also charge that the proposal would effectively end the dual banking system. It is difficult to see how that would be the case. States would remain the primary regulators of the banks they charter, thus preserving the integrity of the dual banking system. The fact that the knowledge and experience from State level supervision will become an integral part of the Federal Banking Commission's policies actually *strengthens the principal of duality,* as the experience and expertise of State examiners is being given greater weight. Getting the FDIC out of the regulation business, on the other hand, does not really tamper with the present degree of duality since the FDIC is a Federal and not a State agency. At the same time, it deals with the long-recognized conflict of interest problem inherent in an agency that internalizes both regulatory and insurance functions.

Let me also make a more general point that I believe, however, is very important. The dual banking system will not live or die because of the presence or absence of a particular regulatory structure. The fate of the dual banking system will be decided in the financial marketplace where the demise of geographic and product regulations may undermine its existence. The excessive emphasis on the future of the dual banking system in the debate over structural reform is thus misplaced and obscures the *real* source of the problems and challenges for the dual banking system.

The Federal Reserve has argued that streamlining the regulatory structure would seriously impede its other responsibilities such as the handling of financial crises, acting as a lender of last resort, managing the payments system and conducting monetary policy. First, the times when banks dominated our financial system are long gone. Today, the banking industry accounts for only 25 percent of the Nation's total financial assets. Of those, the Fed currently supervises only 15 percent. Concentrating on a narrow set of institutions would thus be misleading, and of course the Fed does not do that but focuses on the much broader concept of financial mar-

kets. Moreover, as has already been pointed out by others in this debate, in most of our recent financial crises such as the failure of Drexel Burnham Lambert, the stockmarket crash of 1987, the collapse of the silver market and the bankruptcy of the Penn Central Railroad, the Fed was not involved as regulator but handled the crises in a superior and flawless fashion.

In addition, assuming for a moment a banking crisis has erupted and the Fed has to move in as a lender of last resort, aspects of bank supervision no longer play any role at this particular stage. Thus unless it can be demonstrated that only the Federal Reserve possesses the expertise and experience as a regulator or supervisor that could have prevented the crisis, the argument does not stand up to close scrutiny. As long as the central bank has clear, prompt, and unquestionable access to all data collected from the banking system, including the examination reports, *all* of which is guaranteed in the current reform proposal, regulatory power and direct supervision is not required. The German regulatory structure, for example, which is renowned for its efficiency and effectiveness, is characterized by a single regulatory agency that shares with the Bundesbank, Germany's central bank, a common data base.

This also holds true for the conduct of monetary policy. As one former Governor of the Federal Reserve said, ". . . the supervisory work of the Federal Reserve has nothing whatsoever to do with the formulation of monetary policy. . . . I have never seen a single individual in the Federal Reserve System which formulated monetary policy on the basis of his knowledge of banks gained through examinations only by the Federal Reserve." It would seem that the burden of proof on this matter rests with those that oppose reform. But apart from frequent assertions, it has not yet been convincingly demonstrated how any useful information is obtained from the supervisory process that could not be obtained with another agency doing the supervision. The *critical* condition for adequate and timely policy decisions are the criteria that guide the data collection process itself and the immediate access by those that need the information. It is far less important as to *who* collects the information. If the current collection system continues to satisfy these conditions under the new structure it should be left untouched. If not, it needs to be revised.

Furthermore, if indeed a convincing case could be made that close day-to-day contact is vital for the execution of monetary policy, this does not necessarily have to be linked to regulation, as the Japanese financial system has demonstrated. Moreover, some former Fed officials have actually criticized the supervisory role of the Fed as being detrimental to monetary policy. According to one Federal Reserve Governor, "[S]upervision is too important a function to be the Federal Reserve's part-time job." Another Governor stated that the central bank "should be permitted to devote all of its time and effort to the task of monetary policy, without diverting attention to bank supervisory matters that demand concentrated full-time attention by people especially qualified for the job." And indeed this has been confirmed. A survey of Federal Reserve Governors' participation in votes on bank regulation does indeed uphold the notion that they do not divert their attention to matters of bank supervision. According to this survey taken during 1975, all seven members of the Board were present for only 10 percent of the votes and only four members were present for more that one-fourth of the 283 decisions.

In fact it is not inconceivable that there is a conflict between regulation and monetary policy. Both policy domains involve political controversy not the least because of the Federal Reserve's independence. When bold innovative action might be necessary with respect to regulation, the political side effects of taking such policy decisions might well lead the central bank to defer or at least postpone such action. The history of the Glass-Steagall Act points in that direction.

Indeed according to officials from the Bundesbank, they do not want to get involved in regulatory issues and share responsibility as it may interfere with their independence in the conduct of monetary policy. Drawing again on the experience of the Bundesbank, whose conduct of monetary policy has won much praise around the world, there seems to be no causal linkage between broad regulatory powers and the conduct of monetary policy. The exceptions are regulations concerning capital adequacy where the Federal Bank Supervisory Office is required to reach an agreement with the Bundesbank. Applied to the Federal Banking Commission, one might consider granting the Federal Reserve veto power on such a aspect of regulation.

Finally, given the continued dramatic change in the financial marketplace, I would question the actual relevance of bank regulatory structure on monetary policy. First, as stated already above, the Fed only supervises 15 percent of the depository institutions' assets. Second and more important, the *real* challenge to the Fed's ability to conduct monetary policy comes from the securitization and disintermediation that all financial markets have experienced over the last decade, complicating

the tasks of central banks in assessing and controlling systemic risk and in responding to financial crisis.

Mr. Chairman, the previous analysis suggests that the arguments that have been presented against reform do not hold up to close scrutiny. I have not seen a concrete example that would support some of the broader philosophical points made by the opponents of reform. To the contrary the evidence points in the opposite direction. Unfortunately, this debate indicates the same dynamic that I outlined at the beginning of my testimony and that has derailed every single attempt at reform over the last 20, even 40 years, independent of the majorities in Congress or the political persuasion of the Administration. Short-term institutional interests to preserve turf continue to dominate over the long-term goal of building a regulatory structure that provides the foundation for a sound, stable, and globally competitive banking system in the U.S. If you are looking for an example of gridlock this is a perfect case. It is supported by the fact that numerous officials (including several from the Federal Reserve) once they are no longer affiliated with a particular regulatory institution *do* advocate the consolidation of the system in the direction currently suggested. Most recently this has been demonstrated in an impressive way when eight former regulators endorsed the Treasury's reform proposal. Moreover, in principal all regulatory agencies agree that the time has come to streamline the system. The fact that some resist a possible elimination of *their* regulatory powers is a separate matter, even understandable from their perspective. Your mandate, however, is to act in the public interest. According to the principle of checks and balances it is for the Legislature, the Executive, and the Judiciary to decide whether this interest is being met.

PREPARED STATEMENT OF R. DAN BRUMBAUGH, JR.[1]

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Thank you, Mr. Chairman and Members of the Committee, for the opportunity to testify today on legislation to consolidate the bank regulatory agendas.

As you will see from my testimony, I strongly support the Regulatory Consolidation Act of 1993 (S. 1633) introduced by Chairman Riegle and Senator D'Amato, as well as companion legislation introduced by Chairman Gonzalez of the House Banking Committee. I also support the Administration's proposal to consolidate the bank regulatory agencies, as originally proposed by the Administration in November 1993. Although I will suggest two potential modifications to the proposed legislation, the absence of these modifications would not alter my support for the legislation.

Under the bank regulatory consolidation proposals, the bank regulatory responsibilities of the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Reserve System, and the Federal Deposit Insurance Corporation (FDIC) would be combined in a single agency, the Federal Banking Commission (FBC). Only the FDIC and Federal Reserve would remain, but their responsibilities would be limited respectively to deposit insurance and lender of last resort and monetary policy.

The Need for Consolidation

Among the most important issues involved in the consolidation of the Federal bank regulatory agencies are how the consolidation would affect the competitive prospects and safety and soundness of U.S. banks and the ability of the deposit insurance system to minimize the costs associated with the future failure of banks. Equally important issues arise in the context of the Federal Reserve Board's role as lender of last resort to banks and how the Federal Reserve's role in monetary policy would be affected if it were no longer directly responsible for the regulation of selected banks and bank holding companies. Though the proposals can undoubtedly result in important administrative cost savings for both the Government and banks, those issues have been discussed thoroughly elsewhere, and I will not address them here.

BANK REGULATORY CONSOLIDATION AND THE CONDITION OF AMERICAN BANKING

In discussing bank regulatory consolidation, the Comptroller of the Currency, Eugene A. Ludwig, has talked about a "curious juxtaposition—an expectation of continued long-term decline versus sharp short-term recovery" in American banking. He has expressed the same sentiment by saying that American banking is in "a secular decline relative to other financial services sectors" while simultaneously "in the

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midst of a powerful cyclical recovery" in profitability. (*The American Banker*, September 16, 1993, p.26.)

The apparent paradox of long-term decline and short-term profitability in American banking is an important place to begin evaluating the bank regulatory consolidation proposals. In a number of important respects, federally-insured depositories have been losing market share to other financial service firms for a considerable period of time. In essence, nonbank financial service firms have become more competitive than banks, and now develop and provide many financial services and products more efficiently than do banks. This competition has intensified dramatically since 1980, and will likely continue to intensify.

Banks' market share has fallen relative to their competition in part because regulatory constraints inhibit their adaptation to changing market conditions. The combination of the apparently irresistible force of increasing competition and the largely immovable obstacle of regulation has produced banking's long-term decline. This Committee's recent unanimous vote to allow banks to operate nationwide branch networks is certainly a significant step toward removing one important obstacle. Yet, even this step has taken so long that it helps make the point that relatively slow adaptation to competition is generally the fate of regulated industries like banking.

The recent profitability of banks ironically also points out the fragility of American banking. The profitability resulted mostly from the relatively large drop in short-term interest rates in the past few years, in part during the 1990–1991 recession, that allowed banks to earn record profits by borrowing from insured depositors and lending to the Federal Government through the purchase of U.S. Treasury securities. Banks also began reducing costs. These are not sustainable sources of profitability. Big banks simultaneously went off balance sheet to earn fee income. Banks also sought other fee income, as traditional bank borrowers found other forms of financing in the general capital market.

The net effect is the "curious juxtaposition" to which Mr. Ludwig refers, or the paradox of long-term deterioration and short-term profitability. From the perspective of the Congress, the current period provides some breathing room between the turmoil of the 1980's and early 1990's and the future in which additional turmoil should be expected. At issue today is the role of bank regulatory consolidation in this breathing period.

The Role to be Played by Regulatory Consolidation in the Health of American Banking

Some analysts have criticized the bank regulatory consolidation proposals because, they say, the effort expended on the proposals would be better spent on directly dealing with the competitive disadvantages of the banking industry. Certainly, the Congress should be devoting far more of its time during the breathing room created by recent bank profitability to alleviating the competitive disadvantages of banks, as well as seriously evaluating reform of the deposit insurance system. At the same time, the bank regulatory proposals can play a potentially useful role if the changes that are made indirectly improve the competitiveness of American banks and alleviate problems with the deposit insurance system.

Although this testimony will address these issues in more detail below, there are many examples of how the proposals can achieve these goals relative to what would have been achieved under the current system. Separating bank regulation from the depository function of the FDIC and the monetary function of the Federal Reserve, can increase the likelihood that the FBC will focus more on overall bank competitiveness. The separation of the deposit insurance function from bank regulation, can also help limit regulatory laxity and forbearance when serious difficulties arise in the banking system. There are important administrative cost savings that can also be achieved.

As a result of these kinds of considerations, it is a mistake for critics of the bank regulatory consolidation proposals to imply or for any of us to conclude that the proposals are in principle unrelated to bank competitiveness or deposit insurance reform. There are nonetheless many issues that the Congress ought to address directly regarding the competitiveness of American banking, and the consolidation proposals—regardless of their ultimate effect on bank competitiveness—ought not to be a substitute for that Congressional review.

Regulatory Arbitrage, the Consolidation Proposals, and Smaller Banks

In the past, one of the principal economic justifications for the current multiregulator system has been regulatory arbitrage. Banks with different charters could gain temporary competitive advantages among themselves by playing one regulator off another one. The fact that Wells Fargo Bank recently contemplated

switching from a bank to a thrift charter and that Continental Bank applied to switch from a national to State charter are examples of regulatory arbitrage. The expected benefits of such charter switches, including broader branching restrictions, more merger options, greater powers, and lower regulatory costs, have apparently been enough to justify such roundabout efforts to adapt and meet increasing competition.

With a single regulator, charter "shopping" would quickly become less necessary so long as the advantages of different charter types were distributed throughout the banking industry. Under this condition, there are good reasons for banks and thrifts to endorse the consolidation proposals. The benefits are potentially quite helpful for smaller banks. Approximately 70 percent of all banks and thrifts, for example, have less than $100 million in assets. In the absence of a rationalized regulatory system, smaller institutions will continue to be at a disadvantage to larger institutions—like Wells and Continental—which have significantly more resources to devote to ferreting out relative advantages in the current regulatory maze.

At the moment, the inevitable consolidation of the bank and thrift industries is a slightly euphemistic term for larger institutions swallowing smaller ones. This pattern is influenced by branching restrictions and regulatory limitations on bank and thrift mergers. A single regulator could add pressure to eliminate these restrictions and provide more opportunities for smaller banks and thrifts to expand, including growth through mergers.

Smaller banks and thrifts will need to expand or be absorbed by larger institutions in order to survive. Both demographics and technology is working against the relative well being of smaller banks. The more sophisticated financial products that are increasingly being demanded by older individuals for their pensions and by younger persons using technology to gain access to financial products increasingly will be difficult for smaller institutions to provide. As a result, the mantra of smaller banks, that they provide special services to communities and smaller communities in particular, is increasingly becoming a fiction.

As mentioned above, regulatory arbitrage is used to gain ground relative to other regulated depositories. Whatever benefits can be extracted through regulatory arbitrage, and protection are small and declining in the face of growing nonbank competition. Banks and their regulators should focus far more of their time on how to meet nonbank competition, and regulatory consolidation can be one step in that direction.

The Role of the Federal Reserve

The consolidation proposals would eliminate the Federal Reserve's power to regulate about 1,000 State-chartered banks that are members of the Federal Reserve and 6,300 bank holding companies. A member of the Federal Reserve Board designated by the Board, however, would be one of the five members of the FBC and the Federal Reserve would have access to all information available to the FBC, including all data and examination reports.

In my view, there is no need in terms of the economic strength of banks or the economic well being of the Nation to include a member of the Federal Reserve Board on the FBC. Indeed, from the perspective of bank regulation and the role of the Federal Reserve as lender of last resort, the financial system in my view would be better served if the Federal Reserve were not represented on the FBC. From the perspective of monetary policy, there is also no reason to believe that sustainable growth of real output in the economy, high levels of employment, and price stability—the goals of monetary policy—would be affected if the Federal Reserve were not a member of the FBC, and thus had no direct responsibility for bank regulation.

THE CRITICISMS

Many reasons have been given about why the Federal Reserve should retain its current role in bank regulation. The following is a summary of the problems that allegedly would arise if the Federal Reserve's role is limited as it would be under the proposed legislation supported by the Administration and developed by the Senate and House Banking Committees.

(1) It would impede the ability of the central bank to prevent or to manage economy-wide financial crises or catastrophes, and as a result, would limit the central bank's ability to maintain the stability of the financial system and the effectiveness of monetary policy. Examples of crises cited are the 1987 stock market crash, the bankruptcy of Drexel Burnham Lambert in 1989, the collapse of real estate prices in the late 1980's, and the "credit crunch" during and after the 1990–1991 recession.

(2) The role of observer would limit the information from bank regulation and supervision that is necessary in order to develop adequate monetary policy.

(3) It is a mistake to disconnect bank regulation from management of the economy through monetary policy.

(4) In its role of lender of last resort to depositories, a role that must sometimes be played in times of crisis when rapid decisions may be necessary involving billions of dollars, the Federal Reserve cannot count on examinations and other information prepared by others.

(5) Too much power would be placed in the hands of a regulatory czar resulting in an inappropriate set of checks and balances in the oversight of depository institutions.

(6) One massive agency would be too slow to respond to changes in the financial marketplace.

(7) In order to keep politics out of bank regulation, it is essential to preserve the regulatory role of the Federal Reserve.

Only in a place and time when protection of a bureaucratic empire can be a holy grail, and when terms like "lender of last resort," "payments mechanism," and "monetary policy" can be uttered with near mythological reverence, could any of these arguments be taken seriously, let alone not be derided.

Responses

Lender of Last Resort

The most important goal of bank regulation is to maintain confidence and, hence, stability in the financial system. The reason this is so desirable is that a stable financial system facilitates the efficient allocation of scarce economic resources—the primary function of the financial system. The system accomplishes this fundamental goal by essentially fulfilling two functions: providing a reliable payments mechanism to facilitate transactions and providing a reliable credit mechanism to transfer funds between savers and borrowers to facilitate economic growth.

The payments and credit mechanisms can be disrupted by widespread runs against depository institutions. Protection against runs in our current system is provided by the FDIC as deposit insurer and the Federal Reserve as lender of last resort to depositories. The FDIC protects against widespread runs by providing depositors with a guarantee against losses associated with selected deposits. The guarantee is credible because the U.S. Government stands explicitly behind it. Taxpayers are the ultimate guarantor. In order to protect taxpayers against losses, the FDIC is supposed to resolve all *insolvent* depositories under early intervention guidelines established by Congress in 1991.

In order to protect against widespread runs at *solvent* depositories, the Federal Reserve System was established to be the lender of last resort. As described by many scholars, the role of the Federal Reserve follows principles stated in the nineteenth century—none of which involves direct regulation of depository institutions. The role of the Federal Reserve is to prevent illiquid but *solvent* institutions from being forced to close by making collateralized loans to them when facing heavy deposit withdrawals.

There is no theoretical or empirical basis in economics for the argument that either the role of the FDIC or the Federal Reserve needs to be combined directly with bank regulation and supervision. In order for the FDIC to fulfill its obligations as deposit insurer, it does not need to be directly involved in bank regulation and supervision. Likewise, all the information that the Federal Reserve needs is that a given bank is illiquid but *solvent,* and to know that the Federal Reserve does not need to be directly involved in bank regulation and supervision.

Certainly under the bank regulatory consolidation proposals put forward by the Administration and the Senate and House Banking Committees, both the FDIC and the Federal Reserve would have ample access to information in order to fulfill their responsibilities as deposit insurer and lender of last resort. Even if the Federal Reserve were not represented on the FBC, it could certainly be guaranteed access to all the information that it would otherwise have available to it in order to determine the solvency of banks experiencing liquidity problems.

Monetary Policy

Monetary policy refers to actions taken by the central bank to affect monetary and other financial conditions in the pursuit of sustainable growth of real output, high employment, and price stability. The direct incursion into banking that may be necessary in order for the central bank to pursue those goals is relatively narrow, dealing primarily with the reserves that banks must hold against certain deposits and the rates charged by the central banks for the reserves that banks sometimes borrow from it. There is no theoretical or empirical basis in economics to argue that sound monetary policy requires *per se* that the central bank also have additional di-

rect regulatory, examination, and supervisory responsibilities for banks or bank holding companies.

That sound monetary policy requires *per se* that the central bank have direct bank regulatory responsibility is also not supported by the experience in other countries. The German Bundesbank has no bank regulatory responsibilities, for example. Approximately two-thirds of the central banks in member countries of the Organization for Economic Cooperation and Development also have no bank regulatory responsibilities.

Critics of the bank regulatory consolidation proposals assert that the Federal Reserve must have direct bank regulatory functions in order to have adequate access to information in order in turn to allow it to develop appropriate monetary policy. The Federal Reserve, however, currently regulates and supervises banks that hold only approximately 20 percent of the assets in U.S. banks. Under the regulatory consolidation proposals, the Federal Reserve would be represented by a member of the FBC overseeing all bank regulatory functions. It is simply not a credible argument that the Federal Reserve could not garner adequate information on the banking industry under these conditions in order to carry out monetary policy.

In fact, the Federal Reserve, even without a seat on the FBC, could be guaranteed access to adequate information on the banking industry in order to carry out monetary policy as well as its responsibilities as lender of last resort. Although important, the information that the Federal Reserve requires about the banking industry is no more important than the information that it receives on other sectors of the economy to which it has no guaranteed access, let alone direct regulatory responsibility.

Other changes in the financial marketplace suggest that the Federal Reserve may need to rely relatively less on information from banks and relatively more on information from nonbank financial firms. Due to technological advances that facilitated the development of new financial products, U.S. households in the past few decades have shifted from direct holdings of stocks and bonds and holdings in depositories and life insurance companies to indirect holdings of stocks and bonds through pension funds and mutual funds.

As a result, just as there have been changes in the marketplace affecting bank assets, there have been substantial changes affecting the liability side of depositories' balance sheets. The growth of nonbank money market mutual funds has been a conspicuous case in point. Money market mutual fund balances rose from 1 percent of M2 in 1980 to 10 percent in 1992, and they have continued to grow. (M2 is the second broadest of three main classifications of money comprising the Nation's money supply.) Before 1980, money market mutual funds were not even included in M2 because they were so relatively insignificant.

The fact that money market mutual funds are now included in M2 reflects the new reality that the funds are a close substitute for deposits at banks and savings and loans. A still broader measure of money would show the declining importance of depository liabilities compared to other financial service firm liabilities. The growth of money-like assets available from nonbanks suggests that the Federal Reserve needs to rely relatively more on information from nonbanks in making monetary policy. In contrast, to listen to critics on the bank regulatory consolidation proposals, one would conclude that the monetary sky will fall if relatively minor changes in bank information gathering were to occur.

Checks and Balances and Relative Power

The argument that too much power would be placed in the hands of one regulatory agency, the FBC, resulting in an inappropriate set of checks and balances in the oversight of depository institutions, appears significantly overstated. To the contrary a new, and stronger, set of checks and balances would tend to develop and a greater degree of overall accountability would emerge.

Power would be redistributed based on a stronger set of checks and balances created by the separation of the lender of last resort, the deposit insurer, and the regulatory agency. This redistribution of power would be particularly helpful in preparing for and handling periods of crisis. As discussed below in more detail, for example, the existence of regulation and the deposit insurance function within one agency tends to lead to conflicts of interest.

The same is true in combining the lender of last resort with regulation. In times of abrupt and unexpected difficulties, for example, the Federal Reserve in the proposed regulatory regime would be less likely to abet attempts to cover up the problems through regulatory laxity and forbearance. The reason why is that the Federal Reserve would not be responsible for the regulatory policy that might have or arguably could have contributed to the problems in the first place.

In the system that would be established by the consolidation proposals the lender of last resort would also be more likely to make clear exactly on what terms and with what information it would be willing to lend to an institution experiencing difficulties. It would have a strong incentive to make those conditions known to the FBC. The power of the lender of last resort to be certain that it got the information it needed would be significant. The reason would be that the FBC would not want to be in a situation where solvent banks experiencing a liquidity problem did not have access to liquidity from the lender of last resort.

Overall accountability would improve under the regulatory consolidation proposals. In the current system, accountability for Federal bank and thrift regulation is divided among five agencies, each with different responsibilities. This can make accountability for regulatory policy difficult to discern. Under the system created by the bank regulatory consolidation proposals, responsibility for regulation, deposit insurance, and lender of last resort would be clearly separated. Congress, for example would be able to evaluate each function more clearly, and would be able to make changes as it saw fit. The improved set of checks and balances and the improved accountability would be significant and adequate safeguards against the perceived problems with one Federal regulator for banks.

In our Government, the safeguards against undue power are not tied to the size or scope of a given Government operation, but to the accountability of the operation and checks and balances among Government bodies. This would clearly apply to the FBC and protect against inappropriate exercise of power.

Innovation and Regulatory Responsiveness

The notion that criticism of the consolidation proposals is based in part on worries that the FBC would be too slow to respond to changes in the financial marketplace relative to the Federal Reserve, or that it would be exceedingly risk adverse relative to the Federal Reserve, is particularly amusing given the history of the Federal Reserve in this regard. The Federal Reserve has traditionally been the Federal agency most likely to be slow and the least innovative in response to changes in the financial marketplace. The Federal Reserve has been particularly reluctant, compared to the other bank regulatory agencies, to support additional powers for bank holding companies.

BUREAUCRATIC EMPIRE AT STAKE

Based on a reading of 1992–1993 "Annual Report: Budget Review" of the Board of Governors, the staff assigned or budgeted for bank regulation and supervision appears to have been approximately 3,304. This is slightly less than three times the 1,212 staff members that appear to be assigned or budgeted for monetary policy. These numbers do not include support staff. It is estimated, moreover, that more than 90 percent of the bank regulation and supervision staff is located in the twelve Federal Reserve Banks. Thus, the bureaucratic empire at stake is not only a significant part of the Federal Reserve Board of Governors in Washington but also a significant part of the twelve Federal Reserve Banks.

The dismantling of this empire, not lofty policy concerns of financial stability, appears to be the real source of the concern over the Federal Reserve's role in the consolidation of bank regulatory agencies.

Lessons from the Role of Regulatory Structure in the Thrift Debacle

Concerns have been raised that the regulatory structure that would result from the consolidation of the four bank regulatory agencies would be similar to that of the Federal Home Loan Bank Board, and that the Bank Board's structure contributed to the thrift debacle of the 1980's. The Bank Board was the sole Federal regulator for federally-insured savings and loans until 1989, when it was replaced. It had all of the authority that the proposed FBC would have: the design of regulation, the examination of insured depositories, and supervision of the depositories.

SEPARATING REGULATION FROM DEPOSIT INSURANCE

There was one major difference, however, between the Bank Board and the proposed FBC. The Bank Board was the operating head of the deposit insurance agency for thrifts, the Federal Savings and Loan Insurance Corporation (FSLIC). This created a potential conflict of interest, which subsequently became important in the thrift debacle.

When the entire savings and loan industry essentially became market-value insolvent between 1980 and 1982, the FSLIC had insufficient cash reserves to resolve the number of insolvencies that existed and would have otherwise been resolved if the FSLIC had had adequate reserves. In response, the Bank Board adopted several regulations between 1980 and 1982 that were designed to buy it, as head of the FSLIC, and the thrift industry time. The Bank Board, for example, lowered net

worth requirements, liberalized what could count toward net worth, and allowed institutions reporting insolvency to remain open for lengthy periods of time. It also gave deeply troubled institutions essentially the same access to deregulated asset powers as it did healthy institutions. I believe that most economists who are experts in the thrift debacle have concluded that the net effect of these policies was to increase the total present-value cost of the thrift debacle.

There are good reasons to believe that some of the incentives, if not the outcome, would have been different if the deposit insurance function had been separated from the regulatory function in the thrift debacle, as would exist under the consolidation proposals that would create the FBC. A separate deposit insurer, concerned only with the resolution of savings and loan failures, might have been more vocal about its concern over the fundamental instability of the savings and loan industry. It might have been quite vocal, for example, that an industry required to make long-term, fixed-rate loans funded with shorter-term, variable-rate deposits was a ticking time bomb for the insurer. It might have been more reluctant to go along with a policy of regulatory forbearance once the crisis developed if it concluded that forbearance would increase its ultimate costs.

A change in regulatory structure separating regulation from insurance does not guarantee that the kinds of problems that arose in the thrift debacle will not arise. A pattern similar to the pattern in the thrift debacle, for example, developed in the banking crisis of the 1980's and early 1990's, despite the fact that regulatory responsibility was shared by the FDIC with agencies with no specific responsibility for deposit insurance.

LAXITY AND FORBEARANCE IN BANK REGULATION AND DEPOSIT INSURANCE

In this pattern, the FDIC dramatically understated its expected losses in the late 1980's and early 1990's, when the expected losses grew substantially larger than the cash reserves of the FDIC fund. The FDIC did not resolve all troubled banks that it would have otherwise resolved if its funding had been adequate. It, like the Bank Board, and with the knowledge of the other bank regulatory agencies, engaged in a pattern of regulatory forbearance similar to that of the Bank Board in the 1980's. Unlike the Bank Board, which suffered a second round of difficulties when real estate prices fell in the late 1980's, the FDIC and its fellow regulators were bailed out in the early 1990's by the unexpected relative decline in short-term interest rates that allowed banks to earn record profits.

The regulatory consolidation plan that would create the FBC would completely separate the FDIC from regulation. This would at least create healthier incentives than those that existed when the Bank Board was operating head of the FSLIC or that exist today when the FDIC also has regulatory responsibilities. The FDIC, once responsible only for the resolution of failures, would be more likely to be vigilant against future threats to its insurance reserves, more likely to express its concerns early when problems developed, and less inclined to accept silently regulatory policy that it thought could increase its loss exposure.

In a crisis like the one that befell the thrift industry in the early 1980's—where thrift insolvencies completely overwhelmed the FSLIC's financial capabilities—a completely separate FDIC would also be more likely to inform Congress publicly of its difficulties. The reason would be to gain access to general revenues as quickly as possible and to shorten the period of time that insolvent institutions were open and operating with the perverse incentives to take greater risks than exist when insolvent institutions are open with deposit insurance. It would also reduce the effectiveness of pressure from the Congress or the White House to engage in forbearance because it would be more difficult to get the FDIC to go along with forbearance that it did not have responsibility for designing or implementing.

There have been recommendations that the FDIC chair should be a member of the new commission's board in order to protect the deposit insurance fund. The greatest protection of the deposit insurance fund, however, comes from creating the appropriate incentives, and for the reasons stated above, maintaining institutional separation as completely as possible helps do that. Like the Federal Reserve, the FDIC should be guaranteed access to all records of the FBC including all data and examination reports. This would give the FDIC access to all the information to which it would have access if the FDIC chair actually sat on the FBC board. The FDIC would also be able to address its concerns to the FBC. The FBC would have an incentive to take those concerns seriously not only because the FDIC insures bank deposits, but also because the FDIC, if ignored and independent, would be quicker to complain publicly to Congress about problems than if it were part of the regulatory apparatus.

The Role of the Secretary of the Treasury

Arguing along the same general lines, I would encourage the Committee to consider removing the Secretary of the Treasury or the Secretary's designee from membership on the FBC. In general, the regulatory system will be most effective to the extent that the major functions—regulation, deposit insurance, lender of last resort—are clearly separate. The basic reason is that such separation creates the most appropriate incentives for all of the participants. This also applies to the inclusion of the Treasury on the FBC board.

The Treasury Department, whose responsibilities directly affecting banking regulation have increased since 1989 to include not only the OCC, but also the OTS and slightly more indirectly the Resolution Trust Corporation (RTC). This again can create important conflicts of interest that should be limited to the extent possible.

The thrift debacle provides another example of the nature of the conflict of interest. Even though the Bank Board was formally independent of the Treasury Department, the Bank Board and the Treasury Department basically worked in unison beginning in late 1985 in terms of coordinating what was officially said and done about the cost of resolving failed savings and loans. Throughout the period, official estimates were lower than other credible unofficial estimates, and proved to be extraordinarily lower than actual costs. Internal Bank Board estimates were also uniformly higher than the official public estimates made by the Bank Board and the Treasury. Nonetheless, official estimates drove policy making decisions regarding thrift resolutions.

It is reasonable to infer, that part of the reason that the official estimates were so low was a conflict of interest. The Treasury was concerned about the effect of savings and loan resolution costs on the U.S. budget and budget deficit calculations, an issue which at the time it considered economically more important than the resolution of insolvent savings and loans *per se*. There were also potentially unpleasant political ramifications. As a result, the Treasury Department, despite having been briefed at the Bank Board as early as 1985 and 1986 that the estimated cost to resolve failed savings and loans was between $45 and $50 billion, requested only $15 billion in indirect borrowing authority in 1987. The delay in providing adequate funding to resolve insolvent savings and loans probably increased the ultimate present-value cost of resolution significantly.

In terms of reducing potential conflicts of interest, the proposed regulatory consolidation moves in the right direction by moving the responsibilities of the OCC and OTS from the Treasury to the FBC. By including the Secretary of the Treasury or the Secretary's designee as one of the five members of the FBC, however, the influence of the Treasury Secretary is extended to the extent that the bank regulatory functions of the FDIC and the Federal Reserve are included in the FBC. In so far as the Treasury requires information from the FBC in order to execute its other responsibilities, it can be guaranteed access to information in the same way that information is made available to the Federal Reserve and the FDIC. The Treasury does not need to be represented directly on the FBC.

Effect on the Dual Banking System

Although the States would remain the primary regulators of the banks they charter and the FBC would use State examinations as appropriate, criticism of the bank regulatory consolidation proposals has raised concerns that the creation of the FBC would weaken the dual banking system. The criticism appears to be based on the fear that the FBC would become a more powerful countervailing force than the four current Federal regulatory agencies, and erode the power of State banking agencies.

This fear seems baseless, certainly, in a narrow sense. The creation of the FBC as proposed would not directly affect the States' ability to charter, regulate, and examine State-chartered banks. There may be indirect effects, however, on the rate of innovation in banking and competition between regulators, and they should be evaluated.

State legislation and regulation over time has granted State-chartered banks wider powers than the Congress and Federal regulators have granted nationally chartered banks. Many States, for example, allow State-chartered banks to engage in securities brokerage, general securities underwriting, real estate equity participation, real estate brokerage, real estate development, insurance underwriting, and insurance brokerage. Many of these States also allow entry into the home State by out-of-State banks with either nationwide or regional reciprocity. In the process, State charters have under some circumstances become relatively more attractive than national charters, and this has put competitive pressure on Federal regulators to grant powers that they might not have otherwise.

An issue is whether the creation of the FBC would indirectly erode the attractiveness of State charters by becoming more innovative. There is reason to

think so. As mentioned above, the Federal Reserve regulates about 1,000 State-chartered banks that are members of the Federal Reserve System and is the primary regulator of about 6,300 bank holding companies. Among Federal regulators, the Federal Reserve has traditionally been the most reluctant to grant new powers to banks and to bank holding companies. With reduced influence from the Federal Reserve, increasing competition in the development and provision of financial services, and with primary Federal responsibility for the health of federally-insured depositories residing in the FBC, it is possible that the FBC would accept more innovation in the future than the current regulatory agencies would accept.

Whether this would reduce the attractiveness of State charters and erode the power of State legislatures and regulators, however, is uncertain. It could stimulate additional competition among regulators to provide the optimal array of powers for banks. The far more important issue from the perspective of Congress is whether federally-insured depositories' relative competitiveness and health would improve, and in the process provide greater safety and soundness. I think that it would. Certainly, the Congress should not forego an opportunity to rationalize Federal banking regulation in order to avoid what would in essence be putting competitive pressure on State chartering and regulatory bodies.

If instead the FBC were to follow a path similar to that would have been followed by the Federal Reserve and its fellow regulators, then the State legislatures and regulators would be in relatively the same position that they are in today.

The Inclusion of Credit Unions

Many observers have recommended that credit unions be included in the consolidation of the banking agencies. In 1991, Professor James R. Barth and I evaluated the condition of the credit union industry and its insurance fund. In our report, "The Credit Union Industry: Financial Condition and Policy Issues," we noted that unlike the savings and loans and the commercial banks, the credit unions had reorganized their deposit insurance funding after a period of substantial credit union difficulties by shouldering greater responsibility themselves. We also concluded that the credit union insurance fund was adequate to cover even heavy future losses, and thus posed little threat to taxpayers.

At the same time, we pointed out that there were a number of policy issues concerning credit unions that needed to be addressed by Congress. Credit unions have, for example, evolved into institutions that in many respects compete relatively directly with some savings and loans and banks. This evolution has led to recommendations to alter the special status of credit unions. Other changes have occurred. To gain access to the services of a credit union, an individual must fall within a "common bond," generally involving employment. Over time, however, the common bond restrictions have been relaxed, leading to more competition with other depositories.

Notwithstanding these changes, credit unions are still different from savings and loans and banks. Credit unions are exclusively mutual institutions in which members or depositors "own" the institution in proportion to their shares or deposits. All banks are stockholder owned, and more than 70 percent of savings and loan assets are in stockholder owned institutions. There are advantages and disadvantages to the mutual form of ownership.

The common bond restrictions and mutual form have been justifications for the fact that credit unions pay no corporate income tax. With expanding asset powers, relaxation of common bond restrictions, and questions about the wisdom and need for mutual form of ownership, there have been recommendations that the corporate income tax exclusion be eliminated for credit unions.

Other issues have arisen as well having to do with the structure that allows regular or "natural person" credit unions to place some of their assets in corporate credit unions which in turn put assets in the U.S. Central Credit Union. U.S. Central has deposited substantial amounts of its assets in short-term instruments of foreign and U.S. money center banks without adequate oversight by Congress.

In my opinion, these issues ought to be evaluated at some length by Congress before the Congress decides whether or how to place credit unions within the FBC.

Conclusions

This testimony strongly endorses the Regulatory Consolidation Act of 1993 (S. 1633) introduced by Chairman Riegle and Senator D'Amato, as well as companion legislation introduced by Chairman Gonzalez of the House Banking Committee and the Administration's proposal to consolidate the bank regulatory agencies.

As the testimony also discusses, I recommend that the Committee consider two notable changes, eliminating membership on the FBC for both the Secretary of the Treasury or the Secretary's designee and the member of the Federal Reserve Board

designated by the Board. I do recommend, however, that the FBC remain a five-member commission as a step to ensure independence relative to a three-member commission.

Thank you again Mr. Chairman and Members of the Committee for the opportunity to testify before you today.

R. DAN BRUMBAUGH, JR.

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March 22, 1994

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Senator Riegle:

During my testimony before the Committee on March 4, 1994, you asked me to give you specific examples where the Federal Reserve, as lender of last resort, had made loans to illiquid and *insolvent* banks. The issue is important because the Federal Reserve is supposed to make loans only to illiquid but *solvent* banks.

You will recall that Continental Illinois National Bank and Trust Company of Chicago failed in 1984. At that time, it was the largest bank failure in U.S. history.

According to the 1984 *Annual Report* of the Federal Deposit Insurance Corporation (FDIC) on p. 28, "the FDIC, the Federal Reserve Board, the Comptroller of the Currency and a group of major U.S. banks agreed to provide a 'permanent assistance program' to the Continental Illinois National Bank and Trust Company of Chicago (CINB) and its parent, Continental Illinois Corporation." As part of the assistance program, the FDIC purchased troubled assets from Continental. The FDIC's 1984 *Annual Report* also states on p. 28 that "The purchase of these assets was, in part funded by assumption of $3.5 billion of indebtedness to the Federal Reserve Bank of Chicago (FRB) on behalf of CINB."

Thus, the Federal Reserve lent to Continental Illinois Bank and Trust when it was insolvent without government assistance.

The Federal Reserve also lent to the Bank of New England in the early 1990s. The Bank of New England was closed by the FDIC in 1991. Subsequent accounts revealed that the FDIC had not closed the bank earlier because of concerns over the effect of closure on the bank's off-balance-sheet assets and the effect on other banks' off-balance-sheet assets. This is another example in which the Federal Reserve lent to one of the nation's largest banks when it was insolvent.

As discussed at the hearing earlier this month, the Federal Reserve also lent to insolvent savings and loans in the late 1980s through the shared lending program with the Federal Home Loan Bank of Dallas.

In my view, these activities of the Federal Reserve are inappropriate and are worthy of a thorough review by the Congress.

Thank you, again, for the opportunity to testyify before the Committee. If you would please attach this letter to my testimony I would appreciate it.

Yours truly,

Dan Brumbaugh

R. Dan Brumbaugh, Jr.

PREPARED STATEMENT OF JAMES R. BARTH

LOWDER EMINENT SCHOLAR IN FINANCE, AUBURN UNIVERSITY

Mr. Chairman, and Members of the Committee, I appreciate the opportunity to appear before you today to provide my views on the consolidation of the Federal bank regulatory agencies. This is an important hearing because the current bank regulatory system clearly needs to be restructured. At present, single banking organizations are subjected to overlapping and to conflicting Federal regulations. The responsibilities of regulating and insuring banks, moreover, are commingled in the same Federal agency. It is time to correct these and other problems that impede innovation and efficiency in the U.S. banking industry.

A Regulatory Consolidation Proposal

Under the current regulatory system, four different Federal agencies regulate depository institutions that are insured by the Federal Deposit Insurance Corporation (FDIC). The Office of the Comptroller of the Currency (OCC) charters and regulates national banks. The Federal Reserve Board (FRB), in addition to serving as lender of last resort and conducting monetary policy, regulates bank holding companies and State-chartered, member banks. The FRB also has overlapping responsibilities for regulating the U.S. operations of foreign banks and the foreign operations of U.S. banks. The FDIC, in addition to insuring deposits at both banks and savings institutions, regulates State-chartered, nonmember banks. The Office of Thrift Supervision (OTS) charters and regulates Federal savings institutions. The OTS also regulates savings and loan holding companies and State-chartered savings institutions.

If this particular Federal regulatory structure seems strange and bizarre, that is because it is. The current structure reflects the fact that each of the four Federal bank regulatory agencies was established at different points in time over the past 130 years in response to specific problems. Since their establishment, however, the financial marketplace has changed dramatically, including the fact that the distinctions among the different banks and savings institutions have become significantly blurred. As a result, nobody would design such a structure today. Indeed, the bill introduced by Senators D'Amato and Riegle, S. 1633, provides for a far more sensible Federal bank regulatory structure. This bill establishes a new independent agency—the Federal Banking Commission (FBC). All functions of the OCC and the OTS would be transferred to the FBC. In addition, the bank regulatory functions of the FRB and the FDIC would be transferred to the FBC. Yet, the FRB would retain its central responsibilities to serve as lender of last resort and to conduct monetary policy. The FDIC would also retain its central responsibilities to provide for the insurance of deposits and to resolve troubled institutions in a cost-effective manner.

This proposal for regulatory consolidation, which appears to be quite similar to H.R. 1241 (introduced by Representative Gonzalez) and to the Clinton Administration's proposal (as described by Under Secretary of the Treasury Frank N. Newman in November 1993), provides for three separate and independent Federal banking agencies: a regulator (FBC), an insurer (FDIC), and a central bank (FRB). Such a proposal permits the FBC to focus on safety and soundness issues, the FDIC to focus on containing potential losses at troubled institutions, and the FRB to focus on overall financial stability. It also provides that all examinations and other related information collected by the FBC would be made available to the FRB (and presumably the FDIC). This last provision is included to ensure that under the proposed consolidation there will be as much information as currently available to both the FRB and the FDIC to enable them to fulfill their central responsibilities. While this particular regulatory structure exploits the benefits of a "division of labor," it nonetheless preserves checks and balances through the sharing of information and thus cooperation that must occur for each agency to fulfill its responsibilities.

Benefits of Regulatory Consolidation

The current emphasis on the need to consolidate the bank regulatory agencies is not unprecedented. Indeed, a number of groups that have studied the bank regulatory system on various occasions over the past several decades have proposed consolidation (e.g., the Hoover Commission, the Commission on Money and Credit, the Hunt Commission, the Study of Financial Institutions in the Nation's Economy, and President and Vice President Bush's Financial Regulation Studies). This means there is no need for additional studies—the time for the consolidation of the four Federal bank regulatory agencies has arrived. The benefits of consolidation, such as under S. 1633, are as follows:

ENHANCED REGULATION OF BANKS AND SAVINGS INSTITUTIONS

Under the current regulatory structure, as many as four Federal bank regulatory agencies may regulate a single banking organization. This happens, for example,

when a bank holding company regulated by the (FRB) controls: A national bank regulated by the (OCC), a State-chartered, nonmember bank regulated by the (FDIC), and a savings and loan institution regulated by the (OTS). Multiple regulators assigned responsibility for different parts of the same banking organization lead to potential problems in obtaining an accurate and a timely assessment of the safety and soundness of the combined entity. With a single Federal bank regulatory agency, like the FBC, such a problem does not occur. More generally, more uniform information can be obtained in a more timely manner with a single Federal regulator for each and every banking organization to enhance the regulation of banks and savings institutions.

GREATER CONSISTENCY IN REGULATION

The potential problem of "competition in laxity" exists with more than one Federal bank regulatory agency. The more lenient regulator may be able to induce regulated institutions to come under its jurisdiction so as to preserve or enlarge its client base. This problem disappears with a single Federal bank regulatory agency, like the FBC. More generally, laws and regulations can be applied in a more consistent and timely manner with a single Federal bank regulator of each and every banking organization.

MORE ACCOUNTABILITY FOR REGULATORS

With a single bank regulatory agency, like the FBC, when problems arise accountability is readily apparent. The opportunity for different Federal bank regulatory agencies to blame one another for problems is eliminated. Furthermore, any uncertainty about which Federal agency regulates which institutions also is eliminated. The public, in short, would finally know with greater certainty whether it is the regulator, the insurer, or the central bank to turn to for information regarding specific problems.

POTENTIAL CONFLICTING DUAL RESPONSIBILITIES OF REGULATORS ELIMINATED

The current Federal bank regulatory structure has both the FDIC and the FRB involved in the regulation of banks. This situation creates potential conflicts when the same Federal regulator that is responsible for making decisions about the safety and soundness of banks and savings institutions is also responsible for the condition of the insurance fund, discount window borrowing, or overall financial stability. Consider the case of the savings and loan industry during the 1980's. At the time, the Federal Home Loan Bank Board (FHLBB) was responsible for both regulating and insuring (through the Federal Savings and Loan Insurance Corporation) savings and loan institutions. As everybody now knows, this dual responsibility produced disastrous results. A lesson to be learned is that separating responsibilities among the Federal bank regulatory agencies may better protect the public through greater checks and balances.

LOWER COSTS OF REGULATION

The consolidation of the bank regulatory functions of the four current Federal agencies into one entity should lessen total regulatory costs. A single and more homogeneous set of examiners, supervisors, and reports should yield cost savings that flow directly to the regulated institutions and, in turn, to their customers. In the current environment in which commercial banks and savings institutions are cutting costs whenever possible, it is only appropriate to facilitate these efforts through the consolidation of the four bank regulatory agencies.

Assessing Concerns Over Regulatory Consolidation

There are several concerns that have been expressed over the establishment of a single Federal bank regulatory agency, like the FBC. Three of the more important concerns relate to the potential for another savings and loan-like debacle, the potential for increased systemic risk, and the potential for the elimination of dual banking. Each of these concerns will be assessed in turn.

IS ONE SETTING THE STAGE FOR ANOTHER SAVINGS AND LOAN-LIKE DEBACLE?

Some have expressed the concern that with a single Federal bank regulatory agency, one is simply setting the stage for another savings and loan-like debacle. The specific concern is that instead of involving just a single type of depository institution when there is a regulatory blunder because of the existence of multiple-regulatory agencies, one now would potentially be confronted with the collapse of all commercial and savings bank institutions with only one regulatory agency. But as already indicated, the commingling of the regulation and insurance functions within the FHLBB was an important factor in the savings and loan disaster. The proposed consolidation under S. 1633 avoids this potential problem by putting these two func-

tions in separate and independent agencies. This allows the regulatory agency to encourage innovation on the part of well-capitalized institutions within the guidelines of safety and soundness regulations, while the insurance agency serves as the check on excessively risky activities by taking appropriate action against inadequately capitalized institutions so as to contain its own risk exposure.

More generally, one must realize that regardless of the Federal bank regulatory structure, appropriate disciplinary action depends upon the ability and willingness to identify, measure, and control risk-taking behavior by depository institutions. In this regard, it is important that a single Federal bank regulatory agency, like the FBC, be politically independent, which means the commissioners themselves to the extent possible should be insulated from political influence. It therefore may be appropriate to exclude the Secretary of the Treasury (or the Secretary's designee) as a commissioner of the FBC. In any event, any concern that the proposed consolidation under S. 1633 is simply setting the stage for another savings and loan-like debacle is unwarranted.

WILL SYSTEMIC RISK BE GREATER?

Some have expressed the concern that without "hands-on" supervisory and examination responsibilities the FRB's ability to prevent an event that adversely affects one part of the banking system from cascading throughout the entire financial system will be impeded. Several remarks about this concern are in order. First, under S. 1633, the FRB completely retains its ability to provide liquidity through the discount window and through open-market operations under any and all adverse circumstances. These are the functions necessary for the FRB to contain systemic risk and, more generally, to provide for overall financial stability. Second, supervision and examination responsibilities are not necessary for conducting monetary policy, since the central banks in many countries (e.g., Belgium, Canada, Germany, Japan, and Switzerland) are not assigned such responsibilities. Third, the availability of supervision and examination information to the FRB should not diminish, since the proposed consolidation under S. 1633 requires that all such information collected by the FBC be made available to the FRB. (To the extent that the FRB indicates that either inappropriate information or untimely information is being provided, the proposed consolidation under S. 1633 establishes an important check and therefore a greater degree of accountability on the bank regulatory agency.) Indeed, since the FRB currently only supervises and examines a relatively small percentage of all depository institutions (and not even all of the biggest institutions), the availability of information to it may actually improve. Fourth, as Table 1 shows, the depository institution's share of the financial assets held by all financial service firms in the U.S. has declined from 65 percent in 1950 to 34 percent in 1993. Yet, nobody appears to be arguing that the FRB needs to supervise and to examine all the nondepository institutions that today account for two-thirds of the total assets of all financial service firms. The FRB does need information to fulfill its central responsibilities, which means information collected from a wide range of sources, both domestic and foreign. But "hands-on" participation in the collection of all the important and relevant information seems both infeasible and unnecessary to serve as lender of last resort and to conduct monetary policy.

WHAT ABOUT THE DUAL BANKING SYSTEM?

Some have expressed the concern that a single Federal bank regulator will lead to the demise of the dual banking system. More specifically, the concern is that a single bank regulatory agency, like the FBC, would regulate State banks in the same manner as national banks, thereby eliminating the value of a separate State charter. This, in turn, would deprive the public of any benefits provided by a dual banking system. This is a serious concern because it is indeed the case that the public has benefited from innovations (e.g., checking accounts, electronic fund transfers, NOW accounts, automatic teller machines, and adjustable-rate mortgages) provided through State-chartered institutions that eventually have spread throughout the commercial and savings banks industries. It is therefore imperative that any restructuring of the Federal bank regulatory system not impede the ability of depository institutions to innovate so as to better serve their customers in a continuously evolving financial marketplace. To do otherwise is to threaten the very survival of depository institutions. In this regard, however, the proposed consolidation under S. 1633 does not provide for any additional authority to the FBC over State-chartered institutions. Institutions will still be free to seek a State rather than a national bank charter, with the State in such instances becoming the primary regulator. The important point, however, is that even without any consolidation the FDIC already has authority to prohibit any activities by State banks beyond those authorized national banks if it is decided the expanded activities expose the insur-

ance fund to unacceptable risks. But no such authority to curtail the activities of State-chartered institutions to those permitted federally-chartered institutions is granted the FBC under the proposed consolidation.

The Real Issue May Not Be Consolidation, But Activity Restrictions

The data in Table 1 may help explain the real issue in the controversy over the consolidation of the Federal bank regulatory agencies. As may be seen, depository institutions have been losing market share to their less regulated nondepository competitors, especially during the past decade. (In this regard, deposits insured by the FDIC today fund 55 percent of the total assets of all the FDIC-insured depository institutions and 17 percent of the total assets of all the financial service firms listed in Table 1.) As both domestic and global competition in the financial marketplace continues to intensify, depository institutions are fighting to remain competitive by both cutting costs and increasing noninterest revenues. Banking organizations are accomplishing the latter objective by engaging more heavily in off-balance sheet activities, including loan commitments, letters of credit, and foreign exchange and interest rate swaps. They also are becoming more heavily involved in securities and insurance activities. Existing laws and regulations, however, impede many of these activities. But these laws and regulations do not apply uniformly to all banking organizations. Instead, the greatest freedom to engage in such activities currently is afforded State-chartered banks, bank holding companies, and OTS regulated institutions. To the extent that the FRB is perceived among banking organizations as being the agency most likely to prevent any diminution in current permissible activities and indeed the one most likely to authorize for even greater regulatory freedom, it becomes understandable that both bank holding companies and State-chartered banks, especially those already engaged in broader activities than those permitted national banks, would favor letting the FRB retain or even enlarge its bank regulatory responsibility.

Viewed from this perspective, in order for the proposal for a single Federal bank regulatory agency to receive broader support, banking organizations must be assured that the proposed consolidation under S. 1633 will not impede their ability to compete in a continuously changing financial marketplace by restricting them to an unacceptably narrow menu of products and services that may be prudently offered to their customers. Banking organizations, in other words, may be fighting for both a less costly and a less intrusive regulatory structure. Since the FRB has a demonstrated record of having authorized broader investment powers to banking organizations in recent years, it is understandable that many banking organizations are expressing opposition to a single Federal bank regulatory agency that may turn out to be far more restrictive with respect to permissible activities.

Conclusion

In conclusion, I support the consolidation of the four Federal bank regulatory agencies. And I believe S. 1633 provides a sensible way to restructure the present Federal regulatory system. However, I also believe that: (1) the new Federal bank regulatory agency should be politically independent, and (2) the new Federal bank regulatory agency should let commercial banks and savings institutions compete more freely in the financial marketplace by not curtailing their existing activities and by not prohibiting innovative products and services from being offered in the future by well-capitalized institutions.

Table 1

Percentage Distribution of U. S. Financial Assets Held by All Financial Service Firms: 1950-3rd. Quarter 1993

	1950	1960	1970	1980	1990	3rd. Qtr. 1993
Depository Institutions (1)						
Commercial Banks	51.2	38.2	38.6	34.3	27.7	25.1
U.S.-Chartered	50.5	37.5	36.6	29.3	22.0	19.1
Foreign Offices in U.S.	0.4	0.6	0.7	2.3	3.0	3.3
Bank Holding Companies	0.0	0.0	1.1	2.4	2.5	2.5
Banks in U.S. Possessions	0.3	0.1	0.3	0.3	0.2	0.2
Savings Institutions	13.4	18.7	18.7	18.3	11.4	6.9
Savings and Loans	5.8	11.8	12.8	14.4	9.1	NA
Savings Banks	7.6	6.9	5.9	3.9	2.2	NA
Credit Unions	0.3	1.1	1.3	1.6	1.8	1.8
Contractual Intermediaries						
Life Insurance Companies	21.3	19.4	15.0	10.7	11.4	11.6
Other Insurance Companies	4.0	4.4	3.7	4.2	4.4	4.1
Private Pension Funds (2)	2.4	6.4	8.4	11.7	13.6	15.7
State and Local Government Retirement Funds	1.7	3.3	4.5	4.5	6.1	6.8
Others						
Finance Companies	3.2	4.6	4.8	4.7	5.1	4.2
Mortgage Companies	NA	NA	NA	0.4	0.1	0.2
Mutual Funds (3)	1.1	2.9	3.5	1.4	5.0	8.9
Money Market Mutual Funds	0.0	0.0	0.0	1.8	4.1	3.8
Closed-End Funds	NA	NA	NA	0.2	0.4	0.6
Security Brokers and Dealers	1.4	1.1	1.2	1.0	2.2	3.0
REIT's (4)	0.1	0.1	0.1	0.1	0.1	0.1
Issuers of Asset Backed Securities	0.0	0.0	0.0	0.0	2.3	2.8
Bank Personal Trusts (5)	NA	NA	NA	5.1	4.2	4.3
Total Assets ($ Billions)	294	597	1,340	5,910	12,017	15,055

1. Commercial Banks consist of U.S. chartered commercial banks, domestic affiliates, Edge Act corporations, agencies and offices in U.S. include Edge Act corporations and offices of foreign banks. IBFs are excluded from domestic banking an include all savings and loan associations and federal savings banks insured by the Savings Association Insurance Fund. Bank Insurance Fund.

2. Private pension funds include Federal Employees' Retirement Thrift Savings Fund.

3. Mutual funds are open-end investment companies (including unit investment trusts) that report to the Investment Con

4. REIT's are real estate investment trusts.

5. Bank personal trusts are assets of individuals managed by bank trust departments and nondeposit noninsured trust co

Note: The Flow of Funds Accounts were restructured in the second quarter of 1993

Source: Flow of Funds Accounts, Board of Governors of the Federal Reserve System.

BANKING INDUSTRY REGULATORY CONSOLIDATION

WEDNESDAY, MARCH 9, 1994

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met in room 538, of the Dirksen Senate Office Building at 10:05 a.m., Senator Donald W. Riegle, Jr. (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The Committee will come to order.

Let me welcome our witnesses this morning. We are here today to continue the series of hearings that we have been conducting on the need to consolidate our bank regulatory agencies.

I particularly want to thank Senator Bennett for his help and assistance today.

So far we have heard from a variety of interested parties, including the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Comptroller of the Currency, the Acting Chairman of the FDIC, the Acting Chairman of the Office of Thrift Supervision, and from the Comptroller General of the United States.

In addition, the Committee has heard from a variety of banking and thrift associations, the President of Citizens Against Government Waste, as well as other witnesses from the public and private sectors. Every one of our witnesses, thus far, has agreed that the time has come for us to streamline our bank regulatory system.

This morning we have another very fine panel of witnesses. They include: Bevis Longstreth, Former Commissioner, Securities and Exchange Commission, and presently a Professor of Financial Institutions at Columbia Law School; Donald Howard, a former executive vice president and chief financial officer of Citicorp and later of Salomon Brothers; John Petty, former chairman of the Board of Marine Midland Banks; John Sandner, chairman of the Chicago Mercantile Exchange; Lawrence Connell, co-chair of the Shadow Financial Regulatory Committee; and Edward Kane, who is serving as the James F. Cleary Professor in Finance at Boston College.

So this is an all-star lineup by any measure.

One of the issues that the Committee began to focus upon at our last hearing was the claim by the Federal Reserve Board that its banking supervisory and regulatory responsibilities are essential, as they see it, in order to effectively conduct monetary policy and their ability to deal with systemic risk in the financial system.

Our witnesses last week did not find this argument to be particularly persuasive or compelling given, among other things, that the Federal Reserve Board currently supervises and examines only a relatively small percentage of all depository institutions, and that the banking industry itself, as important as it is, is a shrinking part of the much larger financial system that now amounts to only about one-third of the total assets of the financial services industry.

And, of course, we have indications in other countries where the Bundesbank in Germany, obviously a major monetary policy player and systemic risk player, is not involved in bank supervision such as we think about it here.

So, this morning we want to continue to analyze the need for the consolidation of our bank regulatory system with a particular focus on the arguments as they would relate to the Federal Reserve Board.

Let me just call on Senator Bennett for any comments he has.

OPENING COMMENTS OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

I have no opening statement. I simply want to note that it is nice to have a Banking Committee meeting where Whitewater will not be the primary subject of opening debate.

[Laughter.]

With that, I look forward to hearing from our distinguished panel.

The CHAIRMAN. Thank you, very much. We will go right down the table.

Mr. Longstreth, we are pleased to have you. You bring a distinguished background to this debate. We will make your complete statement and that of all of the others with you part of the record today. We would like you to go ahead and give us your summary.

STATEMENT OF BEVIS LONGSTRETH, FORMER COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION; PROFESSOR, COLUMBIA UNIVERSITY SCHOOL OF LAW, NEW YORK CITY, NY

Mr. LONGSTRETH. Thank you, Mr. Chairman.

I am a partner at the law firm of Debevoise & Plimpton. This year I hold an appointment to the faculty of Columbia Law School as Visiting Professor of Law from Practice and will be teaching a new course in the regulation of financial intermediaries. I have practiced in the banking and securities fields for more than 30 years and served from 1981 to 1984 as a Commissioner of the SEC.

I give you that background because I want to emphasize that I come before you with no special interests linked either to my law firm or any of its clients.

For the simple reason that they make sense, I support the Administration's proposal for consolidation and the legislative proposals to the same general effect that have been introduced by Members of this distinguished Committee.

I am going to divide my testimony into three parts. First, a brief explanation of why I support the consolidation proposal. Second, an explanation of why I think it would be unwise to consolidate into

the Fed. And third, an answer to the principal arguments that the Fed has advanced against this proposal.

First, the case for consolidation: It would, as you all know, reorganize the Federal banking agencies around the three core functions of deposit insurance, central banking, and supervision and regulation.

There is much common ground in criticizing the present system of Federal bank supervision for its unnecessary cost, incoherence, confusion, and lack of accountability.

The need for reform generally along the lines of the proposed consolidation has been widely recognized for at least 55 years, beginning with the so-called Brookings Report in 1939. That Report, as a matter of interesting history, advocated just two agencies. One, the Fed for monetary policy and credit; the other, the FDIC for insurance and supervision of all insured banks and all their holding company affiliates.

The annual cost savings to be derived from consolidation have been estimated by the Administration, drawing on, among other things, a 1992 study headed by Fed Governor, John LaWare, at $150 million to $200 million saved in agency regulatory costs, and a multiple of that, another $3 billion to $4 billion saved in industry compliance costs.

I do not know if those numbers are right, but the cost savings are very substantial by any reckoning.

I think the Administration's concern over costs really matters. It matters today and it will increasingly matter in the future. The financial markets have become global, and to say so is a commonplace today.

This truism means, among other things, that competition among many countries and cities throughout the world to capture a fair share of financial business is not only possible but is occurring with ever-increasing zeal.

As technology inexorably continues to reduce the costs of relocation, the regulatory burdens faced by banks and other financial institutions in electing to conduct business in any one of the growing number of alternative jurisdictions becomes increasingly important.

Yet, the United States is virtually alone in traditionally debating regulatory, tax, and other conditions affecting the banking industry with little reference to the potential consequences they hold for the industry's ability to compete internationally.

The easy assumption of our Nation's preeminence, built up during the post-World War II period, has made it difficult for national policymakers to recognize that domestic regulatory structures serving parochial interests can undermine the strength of our banking industry in the increasingly competitive global market.

In other words, if the U.S. regulatory burden becomes too great, in comparison with that of other world-class financial centers, the much talked of information super-highway will carry financial business away from our shores.

One need only recall the creation of the Eurobond market in the early 1960's, attributable to the Government's attempt to deal with a balance of payments' problem through an interest-equalization tax, to appreciate the potential for large-scale migration of financial business offshore.

It is important to note that, once established, the business lost to London in the early 1960's never came back.

Beyond cost savings, it seems obvious that a single Federal agency for supervision and regulation will go far toward removing the incoherence, confusion, and lack of accountability with which our present system is afflicted.

These points have been forcefully presented to the Committee and I will not repeat them.

So, the obvious next question is: Why not consolidate into the Fed? Consolidation into the Fed, or for that matter the FDIC, would be feasible, and presumably would achieve many of the goals, including cost reduction, that we are talking about. Indeed, instead of ending up with three agencies, there would be just two.

And, if I had to choose between such a consolidation and what we now have, I think I would very possibly elect consolidation. However, I think there are strong reasons, rooted in conflict of purpose, that make the proposed consolidation a far better alternative.

Conflicts exist now both at the Fed and at the FDIC because each combines the supervisory and regulatory functions with a very important and highly visible function which can and does, from time to time, conflict with its role as supervisor and regulator.

The attractiveness of the consolidation proposal is that it would eliminate these conflicts. The problem with consolidation in the Fed or the FDIC is that it would exacerbate them.

Since the Fed has proposed a reshuffling of agency responsibility that would substantially increase its powers of supervision and regulation, and in its testimony, that I had not seen until very recently, suggested that it would be the best choice for consolidation if its proposal is not adopted, and since I am aware of no suggestion that the consolidation take place in the FDIC, I will only address the conflict problem at the Fed.

Its dominant responsibilities center on the conduct of monetary policy and, as lender of last resort, the management of systemic risk and systemic crises. These duties command the interest and attention of the Governors and of top management of the regional Federal Reserve Banks, to a degree far exceeding their involvement in the Fed's supervisory and regulatory roles.

For this reason, in the event of a conflict between the goals of monetary policy—that is, stable growth of the economy without inflation—or avoidance of systemic risk, on the one hand, and the goal of supervision and regulation on the other, the Fed would be expected to, and does, use its powers of supervision and regulation to serve those broader goals, sometimes at the expense of the safety and soundness of depository institutions.

Chairman Greenspan's testimony on March 2, 1994, which, as I said, I had not seen when I prepared this testimony, actually acknowledges that supervisory and regulatory powers give the Fed the "clout," his word, necessary to address systemic risk and the power to see to it that broad economic factors are considered in rulemaking.

In addition, the Fed uses its supervisory and regulatory powers to preserve its independence in the conduct of monetary policy, a feature of its operations long cherished not only by the institution itself but a very broad consensus of the American public. Thus, its

regulatory powers have been used, by way of carrot and stick, to assure the support of a large constituency and to avoid political controversy that might imperil its independence.

Whatever one may think of the possible benefits to monetary policy and the avoidance of systemic risk from allowing the Fed to use its supervisory and regulatory duties in fulfilling those larger roles, it does not always produce sound supervision and regulation. There have been numerous examples of conflicts over the years. A number are mentioned in my written testimony. Here are just two illustrations:

In 1973, Fed officials used personal contacts to persuade banks to hold back prime rate changes dictated by market forces actually set in motion by the Fed's own open-market operations, thus putting at risk the safety and soundness of those banks that complied.

In the late 1980's, the Fed opposed the substantial increase taken by a number of multinational banks in their reserves for loan losses due to the poor quality of loans to lesser developed countries out of a fear that it might disrupt relations between Third World Nations and the international financial community.

Now, let me take a look at the Fed's arguments.

The Fed's principal arguments against consolidation turn on its claim that supervision and regulation are essential to the effective conduct of monetary policy and dealing with systemic risk.

Given the very limited scope of the Fed's direct responsibility over FDIC-insured depository institutions (7 percent) and assets (about 18 percent), it is hard to see how supervision can be essential.

The Fed must, and does, rely on the examinations and reports of other agencies with respect to most of the banking industry. The banking industry, itself, is a shrinking part of the total financial system, representing only about a third of the total assets.

The Fed meets its need for financial information necessary to the conduct of monetary policy from myriad sources, most of which relate to institutions not subject to its supervisory or regulatory powers.

It is equally difficult to find warrant for the claim that its powers to supervise and regulate are necessary to the Fed's effective management of systemic crises.

Because of the eroding importance of banks within the financial system, a source of systemic crisis, more likely than not, will be found among other types of financial institutions—Drexel Burnham being a recent case in point.

The passage of FDICIA significantly increases this probability. Indeed, it was for this reason that Congress included in FDICIA language expressly authorizing the Fed to use its powers as lender of last resort to come to the aid of nonbanks as well as those having regular access to the discount window.

The other arguments by the Fed center on the notion that affording the depository institutions a choice among two or more regulators provides the necessary set of checks and balances to regulatory oversight, thereby enhancing effectiveness.

There is something seriously wrong with the idea that a competition among Federal regulators, fostered by affording those regulated a continuing choice of regulator, is either necessary or desir-

able to achieve the proper goals of regulation, which in this case are safety and soundness of banks.

There are plenty of checks and balances in our system of Government. Congress writes laws it deems necessary to carry out public policy. Congress is accountable to the electorate, as is the President who signs the laws into effect. Regulators implement those laws. They are appointed by the President, confirmed by the Senate, and they have limited terms. They are strictly accountable to the Congress, and subject to review in the courts, for the proper implementation of those laws.

At a time when many citizens are questioning the effectiveness of the Government, and suggesting that costs imposed on them to pay for Government far exceed benefits achieved, it is really stunning to read (in the Wall Street Journal) the Chairman of the Fed declare that duplicative Federal agencies are necessary to assure that Government does its job well.

On its face this is a silly claim, but it is pernicious, too, in furthering the distrust and disrespect of Government that has grown up in recent years.

Beyond theory, fortunately, one can point to many examples of effective regulation by single agencies. The SEC is one, and the FCC is another, to mention only two.

The Fed says dual regulators create, and I quote, "invaluable restraint on any one regulator conducting inflexible, excessively rigid policy," close quote. But bank holding companies have no choice of Federal regulator. Only the Fed.

Presumably, the Fed would not apply its argument for dual regulators to the regulation of bank holding companies, nor would it so condemn its own handling of what are "monolithic" responsibilities in regard to holding companies.

The Fed also argues that consolidation will harm the dual banking system. This system affords the bank a choice of either a Federal or a State charter and, thus, a choice between the different bank powers that, prior to FDICIA, often existed between State banking systems and the Federal system.

Now, with FDICIA, State-chartered banks generally cannot exercise powers as principal that nationally-chartered banks cannot exercise, reducing very significantly the importance of choice in chartering.

To my understanding, the dual banking system has never meant, as the Fed suggests, that the "availability of a State charter carries with it the choice of Federal regulator."

The only choice now is between the Fed, if the State bank is a member of the Federal Reserve System, and the FDIC, if it is not. The decision to be a member or not turns on many business factors unrelated to the attributes of these two Federal regulators.

The Fed also claims that a single regulator may prove more risk adverse than would multiple regulators competing for business, who could be expected more effectively to foster product innovation.

My experience at the SEC convinced me, beyond any doubt, what should be obvious to a close observer of the financial scene. Innovation occurs in the marketplace among competitors, not around the regulators' table.

The SEC's task—and a challenging one at that—is to try to keep up with an explosive creativity in the marketplace it regulates. This is all one can expect of the SEC. It is not charged to innovate, nor does it do so in fact.

Regulatory change occurs because those competing in the marketplace demand it, or sometimes deserve it. The same is true for bank agencies.

One final point on the Fed arguments. The Fed is seriously conflicted in regard to the consolidation proposal because it stands to lose the very considerable power of supervision and regulation of the bank holding companies in whose banks more than 90 percent of all bank deposits are held, and to lose the need for a large segment of its staff.

Carter Golembe estimates conservatively, based on the Fed's own Annual Report for 1992–1993, that the number of Fed staff assigned to, or budgeted for, bank supervision and regulation is roughly three times greater than those assigned to monetary policy.

Since consolidation poses a threat to the Fed's regulatory power over banks and to the size of its staff, it is not surprising that the Fed stands against the proposal.

These conflicts make it highly unlikely that the Fed can bring to the debate an entirely dispassionate and objective eye. These conflicts should also make the Congress cautious in giving weight to the Fed's arguments without the most rigorous and skeptical probing.

Thank you.

The CHAIRMAN. Senator Gramm wants to make a brief statement, and then we will go to Mr. Howard.

OPENING COMMENTS OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, let me thank you for holding this hearing. Unfortunately, our colleagues, like me, probably have three or four hearings today, so we will be jumping back and forth.

I want to thank our panelists for being here. I believe this is a very important issue. I think it is an issue that, as I look at it, I look at the cost of a regulatory agency and I basically see those costs under two columns:

Number one, the cost of the regulations they impose, the impact they have on efficiency and economic growth and job creation; and then I look at the dollar costs to the regulatory agency.

I must admit that, while I have tried in my congressional career to focus on dollars and cents as costs, when I look at regulatory agencies the regulatory costs look, to me, to be a lot bigger.

I think it is clear that the President is moving on this issue. The Administration is going to try to reach a consensus. I believe a consensus is possible. I think that we can move toward consolidation. We can eliminate some duplication that is unnecessary, but, at the same time, I think we can preserve some of the areas where some active competition can occur.

I do not think that Government and competition in the regulatory process are mutually exclusive. I think real concerns have been raised about the President's plan. I am opposed to the Presi-

dent's plan, as it is now written, and so, apparently, is the President. So I believe that we are going to see a change.

I hope, Mr. Chairman, that we can see something worked out that we can move forward with, and that we can have strong bipartisan support. I think the information we are getting today from people who, after all, are experts, who are out actually working and trying to create economic growth under the regulatory process, is important and I thank you for holding this hearing.

The CHAIRMAN. Thank you very much, Senator Gramm.

Mr. Howard, I indicated earlier your background. We are delighted to have you. We would like to hear your comments now.

STATEMENT OF DONALD S. HOWARD, FORMER EXECUTIVE VICE PRESIDENT AND CFO, CITICORP/CITIBANK, SALOMON, INC., AND SALOMON BROTHERS; INDEPENDENT CONSULTANT, ATLANTIC HIGHLANDS, NJ

Mr. HOWARD. Thank you.

I am here, really, only as a private citizen. I represent no one but myself. I am retired as chief financial officer of Citicorp and Citibank.

For 15 years at Citibank my primary responsibilities included the supervision, on a day-to-day basis, of Citi's relationships with all bank regulators. Based on that experience, I strongly support the concept of a single regulatory agency.

Bank supervision has two quite distinct aspects. First, the authority to examine all aspects of bank operations. Second, authority to approve mergers, acquisitions, and new or expanded powers.

In my view, establishing and executing monetary policy has almost no connection to bank regulation. I feel very strongly that the power to examine banks should be vested in a single regulator.

The current duplication of functions is costly, wasteful, and unnecessary. This duplication has evolved over time as financial services and financial markets develop to accommodate changes in the public's real and perceived needs.

Limiting the financial services which any one institution can provide is less and less relevant to the American public, which is becoming increasingly comfortable with obtaining banking services from brokerage firms, investment services from commercial banks, and insurance services from mutual savings banks.

In response to legislative requirements, Citicorp, a bank holding company, had within its very complex corporate structure at least one of each of the following entities: national bank, State bank, Edge Act bank, nonbank, thrift, and nonbank activities.

Citicorp, the parent holding company, is regulated by the Federal Reserve. Citibank was regulated, ostensibly, by the Office of the Comptroller of the Currency. These were the firm's two primary regulators. But, because of the business conducted by one or more entities within the Citicorp legal structure, Citicorp had a reporting responsibility to 17 different regulators. These include the Federal Reserve Board, five regional Federal Reserve Banks, the OCC in Washington and New York, the Federal Home Loan Bank Board, now the Office of Thrift Supervision in Washington, and four regional Federal Home Loan Banks.

The FDIC, and the now-defunct FSLIC, and at any one time two or more State regulators, believed it was necessary for it to review the condition of the parent bank holding company, consolidated Citicorp, in addition to examining those entities for which it had direct supervisory responsibility. The logic was to ensure that the parent Citicorp was a source of strength to the subsidiary, not a potential drain on the subsidiary's resources.

The Fed also took the view that it had to examine or review Citibank using the logic that its financial condition was critical to properly assess the financial health of the entire Citicorp organization.

I believe there was justification to all of these views. Each of the regulatory bodies resisted attending discussions or presentations at which other regulators were present. The result was numerous, repetitive discussions and presentations.

The scheduling of quarterly meetings with these 17 different regulators was a nightmare. One meeting with a single regulator would have saved a great deal of time, and would likely have produced at least as much information and dialog of real value.

Duplication of examinations may be an even greater problem for the smaller banks who do not have the resources available to larger ones.

Three weeks ago I met with the president of a State bank subsidiary of a bank holding company. Both the bank and the parent are moderate-sized institutions. In sequence, the bank has had examinations from the State Bank Examiners, the Fed, and the FDIC. Each of the regulators has individually reviewed and classified each of the bank's business loans. They have very few loans to major corporations.

Each loan has been reviewed, discussed, and classified three times. There are significant costs to the bank. First, they pay their regulators for the cost of examinations. Second, both loan officers and senior management are tied up many hours in duplicative discussions with the various examiners and not available to service customers. After all the reviews and classifications are completed, the bank must charge earnings to provide reserves for each loan based on the most severe classification of any one regulator.

The result is that the loan loss reserve against the entire portfolio is higher than any one of the regulators would require. Because these charges flow through the profit and loss account of the bank, its earnings are reduced, its capital is reduced, and its ability to fund its mostly small business customers is diminished.

The final and most significant cost of duplication is the time spent by senior bank management and its directors in meeting with each of the regulators separately. The added value of these meetings in duplication is de minimis. On occasion the requirements of one regulator contradict those imposed by another.

When this happens, the result is that the bank is in the middle and simply cannot win that situation. The result is an expense that results from the totally wasted time and unproductive activities, but is absolutely necessary, under the circumstances, when the regulators, themselves, cannot agree.

A related issue, but one which should be addressed, is the role within the regulatory process of regional offices of the various regulators.

As more banks and bank holding companies expand across State lines, they enter the jurisdiction of additional regional offices. Particularly in the Federal Reserve system, regional banks asserted a certain amount of independence from Washington. This impact was clearly felt in the extensive time it took to gain approval for new, more expanded powers. All such applications had to be sent first to the local regional office.

For significant issues, that office could only forward their analysis and recommendations to Washington for decision and more delay. There is simply no justification for the cost of duplicate examinations by numerous regulators.

Cost is real and is ultimately paid by the bank customers and taxpayers. However, I believe that for regulators this is not the main issue. The authority to approve mergers and acquisitions and new or expanded powers for the banking system is the key issue.

It is in this respect that there has been an inconsistency between the regulators. This has led to shopping by individual banks to determine which regulator was most likely to approve that specific application.

Frequently, the decision on which corporate legal vehicle to use for the proposed new or expanded authority was determined by the regulator judged most likely to approve.

In my view, the ability to select a regulator who would say 'yes' has been crucial to the progress of the banking system in the last 20 years or so. The OCC and various of the States have clearly taken the lead in this regard.

It has been the Fed which has resisted changes. The banking system has not collapsed because banks can now own thrifts, offer investment services, or even, for a limited number of large banks, compete directly with investment banks as underwriters of public securities.

I do see significant risk to the banking system in the agency consolidation proposal in concentrating the approval power for new or expanded activities.

Banks could be put at an even greater competitive disadvantage than they are now unless the approving authority is sensitive to changes in the markets for financial services and acts promptly to permit U.S. banks to compete effectively.

For banks, I believe, this is either the best of all worlds—if the Federal Banking Commission is responsive—or the worst if it is not.

In my discussions with bankers, many would prefer to deal with the devil they know today than to risk the unknown.

The CHAIRMAN. May I just stop you there? We were talking about that the other day, and I think that is a key issue here. I think history has demonstrated, as you have just said in your testimony, that the fragmented approach, in certain ways, has held back innovation. I think, if you add it all up and look at the trend lines, if you look at banking assets and resources as a percentage of the overall financial system, there is a rather sharp decline.

You have this issue of the globalization of financial markets. No one can predict, precisely, how a Federal Banking Commission, should there be one, on any given day will look, in terms of who is there and what the attitude is. But, it seems to me, the logic is that if there is an entity whose purpose is to think about the business charter and the economic success of that part of the system, that the likelihood of being alert to intervention and competitive pressures, competitive erosion, international circumstances, equity of treatment in international markets, and so forth, that a Federal Banking Commission ought to see that as a central role. In other words, to look after the soundness and the vitality of the business charter, especially if you have a deposit insurance entity that is looking at its issues, and you have these other questions, which are collateral questions, about systemic risk and the payment system and so forth monitoring policy over in the Fed where they will continue to be.

Somebody needs to be thinking ahead about what the nature of the business charter ought to be in terms of the banking system.

I think your testimony already indicates that the nature of this vulcanized system gives you some of that here and there, some of the time, but that, in any over-arching sense, it has been missing. In fact, both of you have already said that the Federal Reserve, in many ways, has been a dead hand with respect to innovation.

So, I think it is time that we focus on the business charter. We have gone through these episodes in the savings and loan and banking systems, with respect to the strength of the insurance fund, and changing, in certain ways, the nature of the regulatory process, but now, it seems to me, the question of what the proper business charter should be, in looking ahead and looking at these new international realities, is a question that really has to be elevated.

If you do not get an effective consolidation with people who are competent and have vision, I am not sure that you are not going to see a continuation of the same trends.

I can understand your point of saying, in some respects it is better to say, well, let us take the devil we know rather than one that may be created for us.

On the other hand, if the trend lines are working the wrong way, it seems to me that that probably is a signal that a restructuring of logic otherwise supports and probably provides a better opportunity for some forward-looking thinking, with respect to what the business charter's thinking ought to be, especially in this changing world.

I have been persuaded, as I have listened and talked with people, that when you weigh that, the weight of the argument comes out on the side of: Let us get a well-balanced, competent, independent Federal Banking Commission that can have that as a central part of its mission and charter.

Now, how many people are on it and where they come from, and how long the terms are, can be debated. There is room to move back and forth on that issue.

I am not sure where else it comes from, especially if you leave in place this smothering, conflicting, overlapping structure that is there now.

The fact that you had to deal with 17 different regulatory bodies at an earlier point in time, I think, makes an important point, one that Senator Gramm also made, which is that we are not just talking about the first-level cost of regulation and how many regulators are on the beat; we are talking about the economic effect of regulation over a period of time when it is not sufficiently streamlined and sensible in terms of what it really costs in economic activity.

That is why, I think, we need to take this step and try to build in the safeguards that deal with some of that anxiety. I just wanted to put in that point. Please go ahead and finish up.

Mr. HOWARD. Senator, I agree with you.

As I say, it is the best of all situations if the Federal Banking Commission is responsive to the real needs of the industry, but there is the risk that it will not be.

In my experience, indeed, it was the Fed that was the least responsive of the regulators in approving new and expanded powers. The Fed always approached new and expanded powers with their own agenda.

If the approval would impact, however minimally, its ability to conduct monetary policy, or if the approval was likely to create political controversy, approval was not granted or, if it was granted at all, it was granted only with significant delay.

Frequently, applications were denied even in the face of the realities of the marketplace. One example was the Fed's long refusal to permit banks to own thrifts. The refusal was based on the curious legal logic that the thrift business "was not functionally related to banking."

As a result, the thrift crisis was more severe and costly to the American taxpayer than necessary. In my experience, the Fed measures every proposal against the impact on its own independence, which is the point that Bevis made, and in its conduct of monetary policy.

The long-term impact on the banking industry was always a secondary or even a tertiary consideration. I attribute much of the relative decline of the U.S. banks and the financial intermediation process to the failure on the part of the Fed to grant the powers necessary for banks to compete successfully.

Going forward in the examination process, one piece that will require even greater expertise and experience, in particular, is reviewing activities in derivative products. It is more likely that the higher-level attributes required of the examiners would be found in one agency rather than diluted into two or more.

If the Federal Reserve were removed from the bank regulation process, would it have any significant impact on its ability to conduct monetary policy? My answer is: Clearly, it would not. We should be looking forward. We should not be looking backward. We should be concerned with the future, not the past.

The role of the banks in the total financial services business has been declining, so that even if the Fed were the sole regulator of all banks, it would have to rely increasingly on open-market operations, access to the discount window, and its central role in the payments' mechanism for successful conduct of monetary policy.

In my career, there have been four changes in the financial markets of such magnitude that, I believe, are irreversible and have fundamentally changed the way the Fed conducts monetary policy.

They have two common characteristics. First, each resulted in the banks being circumvented in the financial intermediation process. Second, the cause of that circumvention was the requirement for banks in the United States to carry reserves against liabilities—deposits in the case of the banks—which are not required of other financial intermediaries.

Deposit reserves are, in essence, a tax borne only by the banks. In chronological order these changes are: (1) the development and growth of the Eurodollar market which Bevis mentioned; (2) explosive growth of the commercial paper market; (3) development of the Cash Management Account which led to the incredible growth of money market mutual funds; and (4) the more recent extraordinary ability of capital markets to securitize bank and bank-type assets.

In the United States enormous sums of money are being gathered constantly outside the banking system and being put to work in productive ways. United States banks are increasingly less relevant to the process, and these trends are accelerating.

The argument that the Fed must be a supervisor to execute monetary policy, to me, is to ignore the facts that the Fed does have powerful tools for executing monetary policy: the discount rate, setting reserve requirements, and open-market operations are tools they have used with great skill over the years and they have accomplished their goals effectively.

Open-market operations combined with access to the discount window, and a central role in the clearance and settlement process, are all vital to the Fed's primary policy goal. None of these tools require direct supervision of banks.

The power to determine access to the Fed's discount window is significant in executing monetary policy. Access is a privilege, not a right. The Fed determines which banks can use the window, for how much, for how long, at what rate, and how frequently.

To make this tool even more powerful, I recommend that U.S. Government dealers, who move billions of dollars every day, be permitted direct access to the discount window. This would enhance the Fed's ability to control market liquidity, and it would also provide the Fed with important information about these movements of funds directly, I believe, improving the Fed's market knowledge significantly.

The Fed's role in the payment mechanism is also critical to its conduct of monetary policy. The Fed is in constant, instantaneous touch with movement of funds from one institution to another, from one section of the country to another. This is the heart of the U.S. economic body.

It's also the source of significant information about the activities of individual banks and their customers. And, in combination with access to the discount window, the Fed has detailed knowledge available on the impact of transactions going into and out of every bank which is a member of the Federal Reserve system.

The argument that the Fed needs the power to examine banks to have a detailed knowledge of what the bank is doing is not credible to me. I know from experience that knowing how an institution

is behaving in money, foreign exchange, and capital markets, is more timely and a better indication of the health of that institution than a superb analysis of its financial statement.

Financial statements and bank examination reports are yesterday's newspaper. Knowing how an institution is behaving today in financial markets, and how other market participants are dealing with them, is vastly superior knowledge on which to make decisions on the health of the individual institution.

That information is available to the Fed in more detail and more quickly than to any other institution or agency. In my view, they do not need additional information sources on individual banks to conduct monetary policy.

In my experience, when the Fed wanted to know anything about what Citi was doing, they called up Citi and asked. To imply that the telephone calls would not be answered just because the Fed did not have regulatory authority seems farfetched.

It was also my experience that the Fed did not utilize field examiners to find out this information. They called when they wanted information and got it direct. The Fed does not require regulatory power to get answers to their questions.

The Fed has acted promptly and effectively in dealing with U.S. monetary crises, most of which have not been triggered by problem banks.

I do not believe the Fed would have acted any differently in any financial market crisis in the past 30 years, had they not had direct regulatory authority. Providing liquidity to financial markets, making reassuring telephone calls, issuing calming press releases, and utilizing their extensive, unexcelled information network to monitor results do not require regulatory powers. Where monetary matters are concerned, bankers do not ignore requests or advice from the most powerful financial institution in the world. This has nothing to do with the ability to regulate.

The changes I described earlier have made the Fed's job of executing monetary policy increasingly difficult and the pace of change is accelerating.

Will the tools now available to the Fed be sufficient for them to carry out monetary policy in the future? I don't know, but I am certain that retaining the power to regulate only a portion of the U.S. banking system is not part of the solution.

It is clear that the primary role of the Federal Reserve is the conduct of monetary policy. That role is so important, I believe carrying out any other function by them should not be diluted even slightly by having any of its resources diverted to any other function, including bank regulation.

Thank you.

The CHAIRMAN. Thank you very much.

Mr. Petty, we'd like to hear from you now.

STATEMENT OF JOHN R. PETTY, FORMER CHAIRMAN OF THE BOARD, MARINE MIDLAND BANKS, INC.; FORMER CHAIRMAN, BANK HOLDING COMPANY ASSOCIATION; FORMER DEPUTY ASSISTANT SECRETARY AND ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY; CHAIRMAN, FEDERAL NATIONAL PAYABLES, WASHINGTON, DC

Mr. PETTY. Thank you, Mr. Chairman.

I'm appearing as an independent business person, although I have had over 40 years in banking and financial markets experience.

My testimony will be limited to making three points.

The legislation should assign to the Federal Banking Commission the explicit responsibility to advance the national interest by assuring that the banking industry is fully competitive in the marketplace and responsive to the commercial and consumer financial needs of the Nation. In other words, the regulators are not just to assure the safety and soundness of banks in order to reduce the contingent liability created by deposit insurance. Rather, an additional purpose of bank supervision should be to help assure a competitive banking industry as a feature critical to our economy.

I believe, sir, that was reflective of the intervention you had with Mr. Howard just a few minutes ago, this added focus.

Second, consistent with the above, regulators should evaluate banks as going concerns and not just assess their value on a liquidation basis. This addition of a second criterion is a subtle point of no small significance.

Third, the central bank's responsibilities with bank regulatory responsibility is not the ideal combination as expressed by Dr. Helmut Schlesinger, President of the German Central Bank, to which I will refer.

Legislation should declare, most explicitly, that it is in the national interest to have a healthy, responsive, and fully competitive banking industry in order that banks may play an active role in serving the commercial and consumer interests of the country.

This is not addressing the obvious; it's legislating the neglected.

To whom did the Nation first look for help in alleviating the recent recession? The uneven response by the banks to this call was a product of things past, and is explained, to no minor extent, by previous Government and regulatory action and inaction. This can be redressed over time with the influence of a Federal Banking Commission whose statutory mandate is to help achieve a fully competitive banking industry, one responsive to the commercial and consumer needs of the Nation.

The Nation has lacked a timely response by Government to changes in the financial marketplace.

Earlier, both Mr. Longstreth and Howard talked about the cost of regulation in dollar terms. The biggest cost, sir, is in time. The time it takes to come to a resolution, the time it takes to give the banks authority to have money market accounts, 5 or 7 years lost, and market positions destroyed as a result of that inaction. The biggest cost is time.

These changes have placed demands upon banks whose capacity to respond has been compromised by stale regulations. While sub-

stantial thinking at the governmental level has been directed toward risk limitation, too little attention has been directed at this official level to the implications of the changing marketplace. What, it should be asked, is the necessary regulatory response to these changes: Would modifying or voiding ancient regulations enable banks to make adjustments dictated by the marketplace?

A quick and effective business adaptation to new circumstances is what makes sustained profits, that ingredient essential to corporate life, and, incidentally, Federal tax revenue, possible. As much as anything else, the shortcomings of the banking industry can be traced directly to the restraints to which bank management is subject, restraints which limit their ability to respond in a timely fashion to the intensely competitive marketplace in which they operate. Slow or delayed regulatory change means a loss of the banks' market share. Regulations conceived under one set of circumstances may lack justification in a changed situation.

The Federal Banking Commission should perform its responsibilities in a manner which facilitates both timely and prudent responses by banks to the Nation's evolving business environment.

Sadly, there is no regulatory body that is sufficiently up to date with competitive market dynamics. The economists at regulatory bodies ordinarily require a 3-year regression analysis of statistics before they will commit themselves about particular developments.

Today, the life of a financial product is less than half that. The event has arrived and taken hold by the time the macroeconomist addresses it. The unhappy truth is that the bank supervisors and the legislation they administer lag so far behind marketplace developments that the banks they limit through regulation slip even further behind.

The CHAIRMAN. Let me just stop you there, because that was an interesting point made earlier by your two colleagues whom have spoken. Senator Bennett was out of the room. I was struck by that and I just want to see if you have the same view.

They were making the point that the Fed, in their personal and professional experience, was the least innovative of any of the bank regulatory bodies that they've dealt with. And that, in effect, what they were describing was an operation that was quite content with the way it was operating and, therefore, it was very difficult to get timely responses to any ideas about innovations or changes in the business charter.

And you're nodding, Mr. Howard, in the affirmative.

Mr. Petty, would that be your experience, or would you dissent?

Mr. PETTY. Absolutely. I definitely agree with that. I can be more explicit and give more details. That's what I was trying to refer to in terms of this 3-year regression analysis.

The macroeconomists want to have a history of the developments. By the time that happens, it takes 6 months to get a uniform questionnaire developed between the agencies and sent out to the banks. By the way, it takes 3 months to answer that, a year to evaluate it.

The CHAIRMAN. Is this one of the reasons then, why, in effect, the banking industry is being carted away by others? It's being repackaged.

In my mind, it's the analogy of what happens when an inner city goes into a downward spiral and everybody moves to the suburbs.

Mr. PETTY. Nonbank banks exist and they skim the rest of the banks' financial markets, the profitable products. Banks have to provide full services. They get skimmed away in the profitable products, and their cost structure becomes more and more progressively adverse.

This is why a delayed response in the regulatory system to the changing marketplace further erodes the competitive position of the banks in the marketplace. It's self-feeding.

The CHAIRMAN. Aren't you then left with this quandary where the banking business shrinks while the number of regulators stays the same?

In your case, Mr. Howard, you cited 17 different banking regulatory bodies that you had to deal with. So they're all out there, working harder and harder on a shrinking operation. So you can see why, at the end of the day, it would be pretty hard to find time to innovate, even if you could innovate.

Mr. PETTY. We gave space to the bank examiners when the financial markets and derivatives came into place a few years in the past. They were simply going to school on what these products were, how you managed them, and what have you. Which is fine. I'm glad that they have that experience. But it's pretty expensive for us.

The CHAIRMAN. Thank you. I just wanted to pick that up.

Mr. PETTY. I recommend that a second criterion for banking examination be adopted. In the legislative assignment of the Federal Banking Commission, it should be made clear that the safety and soundness standard must not be assessed in just a static manner exemplified by the question: Are the loss reserves adequate?

Congress must legislate that banks also be examined on a dynamic basis, as going business concerns, institutions working constructively today for earnings tomorrow. After all, it is the promise of business which appeals to securities analysts and investors and, thus, their ability to raise capital.

This latter point bears emphasis. A key thrust of the bank regulatory process has been more detailed public disclosure of financial information. The evolution of our financial markets has placed increased reliance upon the market's perception of a company's prospects, i.e., give the market the facts and let it assess a company's prospects by assigning a value to the equity or debt of that company.

This, after all, is what disclosure is designed to facilitate. Economic theory and regulatory policy have been moving in this common direction.

The logical progression of such an approach is to have the regulators also evaluate banks on a going concern basis, more in line with the way the marketplace looks at them. This next step should be anticipated explicitly in the legislation.

It can be achieved through the bank examination function taking on an added orientation: instead of relying upon a totally static [read: liquidation] focus, expand to also include a shared or equally dynamic [read: going concern] orientation.

In order to facilitate this added perspective in the bank examination and regulatory process, the national interest objective of fostering a fully competitive and responsive banking industry must be in the legislative mandate to the new Federal Banking Commission.

I'd like you to reflect, for a moment, on the implications of employing a single criterion in the granting of insurance. I've selected the automotive industry as one, Mr. Chairman, that you know particularly well.

The Federal Banking Commission will regulate to limit the calls on the FDIC insurance, so there is no need to tap the Federal Treasury for excessive losses. That's one of the objectives. In this context, focus, for example, on the implications of employing a single criterion in establishing an automobile insurance policy.

Imagine, as with the FDIC, that there is only one automobile insurer in the country. Imagine, also, that the standards for underwriting automobile insurance have, as with the Federal bank examiners, only one purpose in mind: to avoid accidents.

Now, imagine what limitations the automobile insurer would require to grant insurance coverage. Remember, the rules are written for this single criterion: avoid accidents! Would anybody over 65 be allowed to be given a driver's license? Would the initial insured age really be 15 or 16, or more likely mid-20's?

Remember, to avoid accidents is the sole criterion, just like our safety and soundness. Would one-time fender benders be allowed insurance?

Now consider the banking industry. Banks, in effect, have to be insured. The bank examiners are the equivalent of the underwriters in the automobile insurance example and their only mission is to avoid accidents [read: "bank failures"] which may call upon the FDIC insurance fund. Therefore, they can say: Don't drive over 45. Don't turn on red. No cars over 6 years old on the highways. Eighteen wheelers and passenger cars must be on separate roads. One-time offenders are uninsurable.

The automobile business would be very different if the insurance underwriters were guided as they are in my hypothetical case. And the bank industry is a lot different [read: constrained, limited, less competitive, less responsive] because our banking regulators have used a single criterion: avoid accidents.

Surely, our Government and our Federal administrators can assign broader criteria in the bank regulatory function. Surely, guidelines which seek accident avoidance, as well as competitiveness and profits, are not mutually exclusive. Surely, this narrowness in the mission of the regulators which inhibits banks from being competitive must be remedied. Indeed, all the business schools in the country teach that keeping a company competitive is the best way to avoid accidents.

My final point, sir, concerns bank regulation as a central bank responsibility.

The Federal Reserve maintains that they need direct, not just indirect, regulatory authority in order to deal with systemic liquidity risks in the marketplace.

It's true that there are such liquidity risks and it's true that the Federal Reserve is the first agency to go into action by injecting

funds into the marketplace, offsetting the contraction inherent in a liquidity crisis. However, many, I would say, perhaps most of these necessary interventions by the Fed are precipitated by events having little or nothing to do with their bank regulatory responsibilities.

This was the case with the surprise Penn Central collapse in 1970 when I was at the Treasury. This was the case with the sterling/gold crisis in 1967–68 when I was also at the Treasury. This was the case with the foreign exchange crisis in 1978. The 1980's gave us Drexel Burnham, and there are many more examples.

The failure in Ohio of the State-chartered savings banks insurance fund had nothing to do with bank regulation. Yet, the Fed was right there where they had to be.

The Fed has regulatory jurisdiction over only a small fraction of the financial marketplace. Nevertheless, it has demonstrated, consistently, its capacity to respond effectively to financial crises in areas where it has zero jurisdictional regulatory authority. Indeed, the central bank's intervention frequently commences before the precipitating circumstances are fully appreciated. Such is the nature of the financial marketplace.

This intervention, however, has everything to do with the Federal Reserve's responsibility for monetary policy and the mechanics for its execution, the payment system, and the discount window. It has little or nothing to do, whatsoever, with whether Bank A should merge with Bank B; or whether banks should be allowed to have mutual funds.

I will conclude with a quotation from a foremost authority on the issue, the president of the German Central Bank, Dr. Helmut Schlesinger. A very interesting quote from Dr. Schlesinger:

> Another question is whether an independent central bank should have the full responsibility of banking supervision, which implies having the right to close a bank if necessary, to ask for the dismissal of the responsible bank management, to ask for sanctions, etc.
>
> My personal impression is that this is not the ideal combination. If a central bank is independent, it cannot or should not act like a Government authority, like a court, or like a bank policeman. The German practice is to leave the authority to a Government agency. The central bank acts only as an agent; it brings in all its expertise, but it has no authority of its own in this field. My attitude is influenced by the observation that an independent central bank can keep its independence even in the event of a bank failure. It should not be forced to try to save a bank by providing central bank money if there is no very strong case for doing so; there should be no conflict between its supervisory and its other central bank functions, its main function, to keep the value of the money stable.

I really don't believe there's an issue at all about dual banking. I think the legislation preserves it very clearly, just as it preserves the independence of the Federal Reserve.

Thank you, sir.

The CHAIRMAN. Thank you very much.

Mr. Sandner, I just want to say to you, welcome. I also want to say that Senator Moseley-Braun very much wanted to be here. She's down at the White House at a meeting. If that ends, she may arrive, but that's why she's not here now.

We'd like to hear from you now.

STATEMENT OF JOHN F. SANDNER, CHAIRMAN OF THE BOARD OF DIRECTORS, CHICAGO MERCANTILE EXCHANGE, CHICAGO, IL

Mr. SANDNER. Thank you very much, Senator Riegle and Senator Bennett.

I want to thank you for inviting me to appear. I've thought long and hard about these regulatory issues, not merely regulation of banking, but regulation covering the entire landscape of the global financial services arena.

As you know, I introduced a model on behalf of the Chicago Mercantile Exchange to rationalize and harmonize all regulation of financial services. Approximately a year ago, on May 20, I testified before Senator Dodd's Subcommittee on Banking respecting that model.

I think it's a provocative model. But, before I discuss our model, I would like to say that I agree and embrace to the word everything that's been said before me on this panel.

So that I don't fall into the same trap that banking regulation has fallen into, I won't reiterate what they've said. I'll skip much in my opening statement because I don't want to be as redundant and duplicative as the banking and financial services regulation that we are criticizing.

I would like to tell you, although I know you know quite well, Senator Riegle, because you and Senator Bennett have been to our exchange a number of times, what the Chicago Mercantile Exchange has become.

The role of the Exchange today is quite a bit different than it was a couple of years ago when you visited. We have grown dramatically. Much of that growth is attributable to this global financial services landscape and the proliferation of new products and risk management needs in this landscape.

We trade short-term interest markets, the Eurodollar, and Treasury bills. We trade foreign exchange, futures, and options. We trade stock indices, the S&P 500, the Midcap 400, the Russell 2000, the Nikei index, and the FTSI index from London.

The Eurodollar contract is probably the biggest trading vehicle in the world today. Each day, the Chicago Mercantile Exchange trades approximately $700 billion worth of contracts.

The firms that are bringing the business to our floor are the international giants in banking (commercial, investment, and merchant banking), securities firms, insurance companies—the gamut of international institutions. This year, the CME will trade approximately $140 trillion of risk management and asset allocation positions.

When the discount rate changed on February 4, the prior record trading volume on any exchange in the world had been set at the Chicago Mercantile Exchange. It was 1,490,000 contracts in one day. On that day, February 4, we traded 2,400,000 contracts; fully 1 million contracts more than any other time in history. That has been followed by repeated, consecutive, million contract days.

And who brought the trade? The international global institutions, the Mitsui's, the Mitsubishi's, the Daichi-Kon, the Commerce Bank, the Nikei's, the Daiwas. I'm naming all the international

firms. But also the J.P. Morgan's, the Morgan Stanley's, the Goldman Sachs', representing a myriad of institutions.

Twelve years ago, we didn't have one clearing member at the exchange from outside of North America. Today, we have the same number of clearing members, but 45 percent of them are domiciled outside of North America. It's the giants that I told you about, and they're queuing up to clear our exchange.

Unfortunately, many of them drop out of the queue because they get locked into the bureaucracy of trying to get approval, through the Federal Reserve or the Office of the Comptroller of the Currency, as a bank to clear our exchange. But the securities firms can come in and clear our exchange without a problem.

The merchant banks are trying to compete in that world and they face impediments.

Fifty-seven percent of our business is interest rates, Eurodollars. Twenty-seven percent of our business is foreign exchange. Eleven percent of our business is stock indices and 5 percent is agriculture. Three percent is retail. The rest is all institutional.

Trading at the CME will result in $9 billion of deposits into the coffers of the banks in Chicago for performance bonds on those positions.

The volume and open interest is extraordinary. The open interest is the positions that people establish to manage risk and to allocate assets.

Tonight, there will be approximately 6,300,000 positions on the books of the Chicago Mercantile Exchange representing $4 trillion in risk management positions. Who's bringing them there? The banks, commercial banks, investment banks, securities firms, and insurance companies.

We have brought an illustration of the current state of financial services regulation. It's like a maze that the best-trained psychologist's rat could not negotiate.

I believe it was Mr. Howard or Mr. Longstreth that talked about the hodgepodge of that regulatory model. And how it is costly, ineffective, inefficient, redundant, and duplicative. Nobody really talked about accountability, but accountability is a very important issue. Regulatory responsibility is so diffused that nobody knows who's accountable and nothing good results from that.

But, the main point is, the current model doesn't nurture, and that's what Government is all about. Government is supposed to nurture the private sector. If you can't nurture the private sector, the public sector will eventually become a parasite and implode.

What we should be trying to accomplish, and you said it so well, Senator Riegle, we should be trying to generate economic growth, which means jobs in this country. We should nurture the financial service industry.

We're talking about banking at this hearing, but I'm talking about the financial services industry, and I appreciate you permitting me to broaden my focus in this testimony.

You also said that it's very, very important, and it is a key ingredient, Chairman Riegle, that we must create an environment that permits continued innovation. This country would be nothing if we didn't innovate products.

Look at what's happened over the last 20 years. The Chicago Mercantile Exchange created financial futures. There wasn't a financial future anywhere in the world before 1972. Look at the world and financial futures today. Look at what has been spawned from the invention and creation of financial futures.

Financial services now use, as their centerpiece, the risk management and asset allocation ideas spawned by the creation of financial futures. Today, it is the biggest growth industry in the world. The United States created it and should strive to keep it. It should not go the way, and you know quite well, Senator Riegle, the way the automobile industry went a number of years ago. We don't want to spend years recapturing what we should have held firm.

The CHAIRMAN. We're coming back.

Mr. SANDNER. We're coming back, but we should never have lost. If we would have been mindful and continued to innovate and to create a nurturing environment, we wouldn't have lost it. We wouldn't have to be fighting so hard to get it back.

You've asked me to talk about the Treasury's proposal with regard to the Fed's proposal. I agree with everything that's been said here. I think, as far as it goes in banking, the Treasury proposal is a superior proposal because it more effectively consolidates.

Quite frankly, I admire Chairman Greenspan as much as I admire anybody in this country. I think he's one of the most brilliant people that have come along in the last 100 years in financial and economic matters. However, I don't think, in this case, he has correctly assessed his need to maintain direct regulatory supervision and oversight in order to deal with monetary policy. If he's not absolutely correct, then it leads us to the Treasury's proposal, which is much more efficient and effective and eliminates costly duplication.

However, I am not entirely happy with the Treasury proposal. It's fine, and your proposal, Senator Riegle, yours and Senator D'Amato's proposal, it's fine, if you could treat banking as a distinct institution. But, you said it so well, we have to think in terms dictated by a rapidly changing world. We need a wake-up call about the international reality of our markets.

Banking is part of the local landscape of financial services. The local market is inextricably interwoven into the global financial services network. Modern banking is far removed from banking as we traditionally knew it.

If banking had been static, we could regulate it by an institutional model, which we've been doing for 50 years. But, institutional regulation in a rapidly changing world merely spawns more agencies. We're about to create another one with Congressman Leach—a Federal Derivatives Commission to regulate derivatives. We seem to need a new agency because no one knows where else to assign responsibility. If we need regulation of derivatives, and the jury is still out on whether we really have to regulate, nobody knows where to assign it.

That's the problem with institutional regulation, but we're stuck in that mindset.

What I would like to do is take you, for a moment, out of that mindset. We shouldn't be regulating institutions according to the

name carved in the stone above the door. This is a bank, therefore, it's banking regulation. This is a securities firm, therefore, it's securities regulation. This is an insurance company, therefore, it's regulated differently.

We should not be regulating an institution based on what the institution is called. When you tear down the veneer, get past the facade of a financial institution, and go inside, they all look remarkably alike.

Banks are selling mutual funds and insurance products. Securities firms are taking deposits and making loans. Insurance companies are managing poole investment vehicles. They're all trying to be competitive, so they're all involved in the risk-management industry, the asset allocation industry, and in the derivatives industry. They are using the exchanges and the over-the-counter market.

All of them are involved in risk management and asset allocation, because if they were not involved, they could not be competitive.

This global market is growing exponentially. The firms using the market are growing exponentially. The products are proliferating—6 years ago, had you heard of a swap? I would have been more likely to hear of it than you, but I wasn't aware. Six years ago, we were in the dark about swaps, hybrids, swaptions, etc.

The financial engineers are proliferating, and God bless them. I don't say it in a pejorative sense. We need that to compete.

Depositors are now investors. The lesser-developed countries that used to borrow money from other countries and central banks are now the emerging markets, and they're not borrowing money. They're going to the capital markets for the money. It's a global market.

National boundaries are irrelevant, it is totally international. And the banks are inextricably involved, like the warp and the woof of a loom, in that marketplace. So, to regulate them as a depository institution that loans money is missing the boat. It's going the wrong way down a one-way street.

I would like to suggest that we move our mindset to a functional regulatory mindset. We should regulate institutions, not according to what they're called, but according to their functions. When you tear down the facade and the veneer, you go in and you look at the functions that they're performing. If they're trading derivatives, futures, and risk management, they should all be treated alike, whether it's an insurance company, whether it's a securities firm, or whether it is a bank. If they're taking deposits and disclosures have to be made, all of them ought to be treated the same.

But you can't do that with an institutional regulatory mindset because it becomes too compartmentalized and fragmented. Even if you periodically consolidate the agencies, which is better than not, you immediately begin to spawn more agencies, just the way it has happened since the 1930's or even before that in 1913, when, I think, it was the Office of the Comptroller of the Currency that was born.

We have a rare window of opportunity that we haven't had for 40 or 50 years because we've gotten the wake-up call. We want to compete and you want to do something about it. I really commend you for it, because a year and a half ago, nobody was talking and

we now know, we're trying to do it, and we're crying out to change it and to become efficient, cost-efficient and regulatorily efficient.

We're crying out to be able to innovate and compete. I think the best way to keep us competitive is through functional regulation.

If you'll look at the graphic depiction of the CME's model, you'll see our concept for functional regulation. You will see that every product sold and service performed by an institution, whether it's a bank, an insurance company, a securities firm, a Chicago Mercantile Exchange, or an over-the-counter market, fits somewhere in there.

We don't have to try to jury rig the structure or create another agency each time a new product or service comes down the pike.

The current regulatory structure creates inconsistent: capital rules, risk analysis, and auditing standards. That lack of consistency is terribly destructive to banks and other financial institutions. Our model consolidates those functions under the division of prudential and systemic risk. Everybody's treated alike. All auditing functions are performed by a professional service operational division shared by all the substantive divisions.

There's only one General Counsel. There's only one chief accountant. There's only one chief economist, and everybody is harmonizing and rationalizing the regulatory framework.

I commend you, Chairman Riegle, for trying to get something done. It's long overdue. And you've stepped out to do it. Unfortunately, you're limited because you're the Chairman of the Banking Committee. But, I think, if you had your druthers, and you could step out and wash the slate clean and say, I'm not just the Chairman of the Committee, I want to do something for the entire financial services industry, you would come up with a functional model.

I don't want to put words in your mouth, but you'd come up with a functional regulatory model. I urge you to start to think in that direction.

Thank you very much.

Senator BENNETT. If I could just make a comment. I've been called away, but I appreciate this and I leave you with this thought that comes from my father. You say that the Chairman could do a whole lot better if he weren't just the Chairman, if he had a clean slate. My father said, "We legislate at the highest level at which we can obtain a majority."

[Laughter.]

Mr. SANDNER. Get the votes.

The CHAIRMAN. Here's part of my majority right here, so thank you very much for your comments.

I just want to say that I've served as Chairman of this Committee for 6 years now, and 18 years on this Committee, and have also had the chance to serve on the Finance Committee, and on the Budget Committee, which are the three financial intersection Committees in the Senate.

I'm the only Senator of the hundred that's in all three places. But it affords an opportunity to get more of a sense for the dynamics of how the economic system works or doesn't work. If you've got Michigan under you as a base, that helps, too, because you get the auto industry and a lot of other things.

The rate of change has been at light-speed. I think your point about what swaps were 6 or 7 years ago, or other things, was enlightening. We've gone hurdling into a new global reality that we're not conditioned to be able to assimilate in real time.

There's too much happening at once, whether it's the fall of the old Soviet Union and other illustrations, or what have you. I think we're way behind in understanding what's happening, and the market doesn't wait. The market goes on. It's out there and we're lagging way behind with this regulatory structure that's almost like an old one-room post office where you go in and everything gets sorted by hand.

It's not quite that bad, but our structure was designed for another time and other circumstances, and the reality has raced away from the structure.

Now what happens, and I think that governmental bureaucracies just tend to do this, is they are so self-protective, they sink deep roots down.

We had testimony the other day that revealed that three-quarters of the personnel base of the Fed is in banking regulation, and if you were to shear that off and just concentrate on systemic risk, the clearance system, and monetary policy, you wouldn't need all those bodies out there.

Of course, that's very threatening to an institution. And, I think we're running into that. You're seeing a lot of gorilla dust being thrown up about how bad it would be if we came in and did some tailoring and some reshaping.

I've seen this a thousand other times. Bureaucracies virtually never want to surrender anything. When I think of 17 regulators coming in and elbowing one another over a shrinking market sector, you can see why, as time goes on, that's just going to continue. The less there is to work with, the more intense the focus is going to become.

Meanwhile, anything that can get lose from that and go out and function in some other way is going to be long gone. I think that's what we're seeing. We're seeing banking, per se, repackaged in front with a different facade and a different name.

It's one thing if we were living on an island, disconnected from the rest of the world. But in the international world of economic realities that we live in today, if we're not adjusting and out on the forefront, I think there are huge problems associated with that.

We've seen that, as you say, in the industrial sector. I wouldn't want to imagine where we would be if what innovation there has been, that you cited, for instance, at the Mercantile Exchange, were sitting over in Tokyo today, or sitting some other place. I don't see how that helps us in a lot of different ways.

I think the time has come to consolidate. I think we have a window of opportunity here because you've got a Treasury Secretary who came out of the Senate, who understands these issues pretty keenly, and is willing to surrender some power and some turf for the sake of a better regulatory structure. You need to have that willingness and you need to have a President who wants to do it.

The time is now. And, of course, the Fed is fighting a very vigorous rear guard action in order not to have to move on consolidation, to any appreciable degree, at least as far as they're concerned.

I thought your point was very interesting. It's one thing to argue for competition in the regulatory banking system. But when it comes to bank holding companies, the Fed is not suggesting to put somebody else in the business to compete with them.

So, if somebody doesn't like the way the Fed's regulating it, it's not like they can go down the street and sign up with somebody else. It's an absolute contradiction and their argument just doesn't hold water. It just shoots a hole right through their whole theory when they want to maintain sole control over bank holding companies. They want to have it both ways. They want the contradiction in a way that serves their institutional interest as they see it.

In any event, this is a wonderful hearing record that we're building here today and we've got Members scattered all over the place that can't be here for one reason or another. I want to make sure that all Members will have a chance to hear and absorb this testimony because I think it's so highly relevant to these decisions.

But, Mr. Connell, you've been waiting patiently, and Mr. Kane, who's been here before with us, let's get to you and then we'll try to finish up here.

STATEMENT OF LAWRENCE CONNELL, CO-CHAIR, SHADOW FINANCIAL REGULATORY COMMITTEE, WASHINGTON, DC

Mr. CONNELL. Thank you, Mr. Chairman, for inviting me and Professor Kane to offer the comments for the Shadow Financial Regulatory Committee on proposals to consolidate bank regulatory apparatus.

The Shadow Committee has issued two statements on the subject; one on December 13, 1993, commenting on the U.S. Treasury Department proposal, which we regarded as a good first step.

Then we followed that up, some 2 months later, with statement 103, which set forth certain objectives and principles which my colleagues, who are much experienced in bank regulatory matters, felt were important when you're dealing with regulatory structure, whether it be the Treasury proposal or Mr. Sandner's proposal which, by the way, I think is very interesting, and has a lot of concepts which should be taken very seriously.

Let me begin with the objectives and relate them very quickly to the proposals of Treasury and the Federal Reserve.

Clearly, the operational efficiency of regulatory agencies, the Government, and the institutions that they regulate are important, and we feel that the Treasury proposal meets that criterion better than the Federal Reserve's for two reasons.

There's only one agency, not two, at a savings of $150 million to $200 million a year, estimated, but more important again, a lessening of the burden on the regulated itself, which allows them to operate more efficiently.

The second, is efficiency of financial markets in the allocation of resources. And that brings products and services to the consumer at the lowest cost. The Treasury proposal would meet that criterion, and, in particular, in regard to the burden of the Bank Holding Company Act administration under the Federal Reserve, has brought to that efficiency in markets. That's very closely related to the third objective.

Innovation in financial markets. Mr. Chairman, you mentioned the chartering function and the importance of that. It's the chartering function that provides the dynamism of change in corporate life, whether it be a bank, an insurance company, or a general corporation.

In the case of banking, the basic charters are provided by the Federal Government with the Comptroller of the Currency and the Office of Thrift Supervision, and by the various State authorities.

The Federal Reserve, while not directly a chartering agency, has essentially assumed that role in its administration of the Bank Holding Company Act. And, over the years, since it acquired that authority in 1968, its slow response has contributed to the loss of market share that you and others have mentioned earlier.

I would also add that the regulation Q administration, over that period of time, largely spawned the mutual fund industry. To continue the Federal Reserve in the regulatory role, I think, will only stifle institutions in the years ahead.

The fourth objective is minimum deposit insurance loss exposure, and certainly the experience of the 1980's has highlighted that. We believe the Treasury proposal could be improved by including the Federal Deposit Insurance Corporation on the Commission because its funds are greatly at stake in all of this.

Fifthly, is effective monetary policy. The Shadow Committee believes monetary policy would be more effective if the Federal Reserve's attention were not diverted by regulatory issues, and also the concern that there's a conflict often, or can be a conflict between regulatory responsibilities and monetary policy.

The Committee also came up with a number of principles for accountability and regulatory behavior, and they are the following:

Clarity in goals and policies. When you have four agencies, you find that clarity of goals is just not possible. The Treasury proposal would improve that.

The transparency of policy decision and underlying decision criteria. In other words, why were the things done. It's very important that whatever the structure is, full, honest, and timely information be provided to the public so that accountability can be achieved.

Third, insulation of policies from short-term political decisions. We believe the Treasury proposal falls short in that respect because the Secretary of the Treasury is a member of the Commission, and we suggest substituting the Secretary with a Federal Deposit Insurance Corporation representative.

Fourth, the assignment of potentially conflicting goals to separate agencies. What that means, really, is that for the achievement of accountability, it's better to externalize conflicts, get it out on the table where the public can see the different issues more clearly and then understand the efficacy of whatever the policy decision was.

Whenever someone tries to tinker with the Federal Reserve's regulatory authority, the Federal Reserve brings up the specter of damage to its ability to deal with systemic risk and liquidity crises.

The Treasury's proposal does not, in any way, disturb their real role in dealing with the systemic risk and liquidity crises, mainly because the tools are the discount window, open market operations, and the payment system authorities. But, once the Federal Reserve raises that specter, everybody takes a dive; Members of Congress,

elected officials, the industry itself, and even economists in the field.

The CHAIRMAN. Why do you think that is? Why does everybody take the dive that you cited? I agree with you.

Mr. CONNELL. I think for two reasons. One is the basic secrecy that surrounds monetary policy. It's a field that people don't feel comfortable with. To me, it's a myth.

The CHAIRMAN. It's interesting. This is how I described it the other day. If you remember the movie the "Wizard of Oz," at the end of the movie, there's this fellow behind the curtain, and he has this huge, fearsome voice that radiates out and intimidates everybody and then the little dog goes up and pulls the curtain back and it's a person there just like all the rest of us. He's created this huge, and I don't mean to personalize it to a person in that movie, but I think the Fed, in effect, has done just that.

They've created this impenetrable——

When he pulled the curtain back, it sounds like garden variety bureaucracy in many ways to me. Impenetrable curtain is what he said.

If the Fed were to lose three-quarters of their personnel staff that are scattered around the country doing bank regulation, if that came under somebody else's umbrella, I'm not sure how much longer they'd want to stay in the business of banking regulation if they didn't, in fact, control the whole fiefdom.

Mr. CONNELL. Yes, Mr. Chairman. And I think that while the Federal Reserve staff are superb in quality and dedication——

The CHAIRMAN. I would agree with that.

Mr. CONNELL. The role is just not suited for the regulatory side.

As was mentioned earlier, there's an institutional incapability of exposing the Federal Reserve to the pressures from the outside when an issue might be taken on, such as the ownership of an S&L by a bank holding company or engaging in the insurance business. It's just not going to be put at risk. A chartering authority will take that risk and take the heat up here or wherever else and the decision then rendered accordingly. But, if you look very carefully at the Federal Reserves authorities that now exist, I'd like to focus in on the payment system authorities.

A lot of people look at the discount window and say, well, they can still lend. Well, not everybody has to borrow, but every financial institution has to clear its checks and transfer its funds. And the Federal Reserve has very pervasive authorities in there. Each institution has a limit on how much they have in exposure to other banks during the day. It's called the daylight overdraft limit.

The information the Federal Reserve gets through that function, it's ability to monitor the flows of funds and the health of institutions involved in that process, give, it, really, all the authority it ever needed. It reminds me of the days, a few years ago, when I was advising some of the Federal Home Loan banks as the S&L industry fell apart, and, in that process, I was analyzing their information flow.

There were three types of ratings for an S&L. There was one from the credit side of the bank, one from the supervisory side, and one from the examination side.

I found, in every case, that the credit side of the bank was downgrading the savings and loan and limiting it's authority to borrow before the examination side was finding out it was a problem bank or a problem S&L.

I think, over time, the same thing would happen with the Federal Reserve. They would do things somewhat differently in the monitoring of banks, but they would do it through their credit and payment system function, when they could do it just as effectively and maybe even more effectively without the regulatory burden.

The last point I'd like to make, Mr. Chairman, is that some people have argued that the Federal Reserve needs this regulatory authority to arm-twist or persuade banks to take risks in crises, such as lending to the less-developed countries or the governments and so on.

I think that's just dealing with bigger problems in the future. It's better in that kind of situation that the credit risks be borne directly by the Federal Reserve and not indirectly through its conduits.

That concludes my testimony, Mr. Chairman. And thank you for inviting me to speak.

The CHAIRMAN. Mr. Kane, you're batting cleanup today. We'd like to hear from you now.

STATEMENT OF EDWARD J. KANE, JAMES F. CLEARY PROFESSOR IN FINANCE, BOSTON COLLEGE; MEMBER, SHADOW FINANCIAL REGULATORY COMMITTEE, CHESTNUT HILL, MA

Mr. KANE. Thank you very much, Mr. Chairman.

I appreciate, greatly, this opportunity to add my perspective, as an academic, to help your Committee identify what are the real issues and what are only the imagined issues in the debate over regulatory consolidation.

What makes this debate hard to decode is that efforts to reassign deposit institution regulatory turf have covert as well as overt dimensions, as previous witnesses have been saying. Overtly, all parties want to serve taxpayers better. Covertly, parties pursue narrower goals and agendas that, in varying degrees, conflict with this estimable objective.

As usual, the front-line warriors in the struggle for financial regulatory consolidation are the Treasury, on the one hand, and the Federal Reserve on the other.

Overtly, both parties seek a framework of prudential supervision that would have three properties. First, it would be easy to understand and cost efficient, something which our current structure is not. Second, it would dovetail with effective strategies of monetary control. Third, it would be responsive, over time, to opportunities offered by evolving technologies of information, communication, and financial contracting.

But enough conflict exists among these overt goals that either agency can promote a hidden agenda merely by ranking these overarching objectives in a way that meets the unacknowledged purposes.

Late last year, Treasury officials renewed the debate and redefined interagency battlelines by identifying potential benefits that institutions and taxpayers might reap from eliminating overlaps in

institutions and taxpayers might reap from eliminating overlaps in Federal supervisory and regulatory authority. Without supporting evidence, three principal classes of benefit were asserted: increased accountability due to a more straightforward bureaucratic structure; greater operational efficiency made possible by bureaucratic consolidation; and more flexible and less conflicted responses to evolving technological opportunities.

Emphasis was placed on eliminating longstanding bureaucratic conflicts of interest that have come from housing contradictory responsibilities in a single agency: between the Fed's monetary responsibilities and its supervisory and regulatory dominion over bank holding companies and State-chartered member banks; and, again, between the FDIC's narrow concern for protecting deposit insurance reserves and its broader regulatory and supervisory responsibilities.

Fed spokespersons have reacted as if they perceived the Treasury's overt objectives to be an ignoble and covert turf grab, aimed at reducing the political clout of the Fed, and further curtailing the ability of State deposit-institution regulators to influence Federal banking policies as strongly as they did during the unfolding of the deposit insurance mess.

Articulating these suspicions has turned the debate into a high-profile shouting match. Top officials from the Fed have openly ridiculed the Treasury plan and countered with a still-evolving consolidation plan of their own.

The Fed's counterproposal incorporates three turf-protecting thrusts. First, Fed officials denigrate the accountability issue by asserting that the threat of punitive use of regulatory authority is essential to effective monetary management. Second, they argue that equal operational efficiency and even greater technological adaptiveness could be obtained as benefits of regulatory competition by keeping two Federal banking regulators in play at the Federal level. Third, they used their responsibility for crisis management as a fulcrum for time-honored scare tactics that assert that the Nation's economy faces a dire future unless the Fed is made one of the surviving regulators.

Fed spokespersons claim, without objective evidence or logical argument, that our central bank would have done an even worse job in dealing with the 1990–93 economic slowdown and in the 1982, 1985, and 1987 liquidity crises, had it not enjoyed, and I quote: "direct, hands-on involvement in supervision and regulation."

The spectacle of Fed officials congratulating themselves for not having altogether fallen on their face in recent years is amusing. But it is instructive that these officials have not chosen to compare their monetary policy success with countries such as Germany or Switzerland that have operated very effectively under a split structure.

The Shadow Financial Regulatory Committee issued, as my colleague, Larry Connell, mentioned, statements on regulatory consolidation in December 1993 and again this February.

The Shadow Committee's statement number 100 suggests an important but straightforward modification in the composition of the Banking Commission proposed by the Treasury. Substituting the FDIC Chairman for the Secretary of the Treasury would better bal-

ance the governing board and neutralize concerns about the Treasury's gaining turf and gaining credit allocation leverage.

More importantly, the statement urges that the internal organizational structure of the consolidated agency be designed to enhance accountability.

Part II of the Committee's statement number 103 cites five principles of organizational structure that foster accountability in monetary and regulatory policymaking. Each is very brief, but took us many months to hammer out, and so I urge your Committee to pay close attention to them.

The first is clarity in goals and policies. The second is transparency of policy decisions and underlying decision criteria. Third, is consistent application of policies across institutions and over time. The fourth is insulation of policies from short-term political considerations. [Note, we're not seeking to bar long-term political considerations because long-term responsiveness is required for a well-functioning Republic.] Fifth, assignment of potentially conflicting goals to separate agencies.

In the past, Fed officials have often compromised on political insulation, while honoring the other four conditions only in the breach. My own past research and past testimony before this and other Congressional Committees emphasizes that the Fed's internal structure is directed toward suppressing, rather than enhancing accountability.

Experience tells us that the Fed is not prepared to revise its internal behavior to let outside observers see whether and how it minimizes the adverse effects of its monetary stabilization activity on the fabric of regulated institutions.

Unless Congress adopts and applies principles like the ideals enunciated by the Shadow Committee, it cannot reasonably permit regulatory and supervisory responsibility over any banks or bank holding companies to remain with the Fed. Such an assignment would make a mockery of the consolidation exercise.

To conduct monetary policy and run its discount window, what Federal Reserve officials need is not a friendly and conflict-prone supervisory relationship with top officials of major banking organizations, but rapid access to reliable information on the changing condition of individual institutions and of the financial system as a whole.

The current information system and supervisory structure fail to give Fed policymakers such access now, and the Fed plan offers no improvements on this score.

A major advantage of pushing the Fed, kicking and screaming, out of the supervisory and regulatory business would be to force Federal regulators to address two problems: one, of collecting more meaningful information from banks, and, two, of making this information base fully accessible across agencies.

Finally, I wish to express my astonishment that Federal Reserve Governors could expect the public to believe that the Treasury's proposed Federal Banking Commission would be "a monolithic monopoly regulator" bound to operate in an inefficient and inflexible manner.

Intense competition for the right to provide financial regulatory services on the Federal level has existed in financial markets for

at least 25 years. And the competition has expanded steadily into other governmental jurisdictions.

Competitive pressure can be counted upon to remain intense enough to generate strong market discipline on Federal banking regulators, irrespective of whether Congress votes to consolidate their functions.

Far from having a monopoly, the Federal Banking Commission would have to compete with private and governmental entities.

By private entities, I mean exchanges and clearinghouses, and by governmental entities, I mean commissions all around the world and in various sub-national jurisdictions.

The FBC would have to compete with entities for regulating nonbank financial institutions and the foreign activities of U.S. banks.

As financial markets have globalized and nonbank institutions have developed more and better substitutes for traditional banking products, a phenomenon all my colleagues on this panel have alluded to, multilevel and cross-industry foreign, State, and Federal competition for the right to regulate financial services has simply become unrelenting.

Continued advances in the technologies of information, communications, and financial contracting can be counted on to keep the Federal Banking Commission under disciplinary pressure from a host of substitute regulators. If the FBC does a bad job, its dominion will shrink and its industry will come before your Committee to complain about it.

Indeed, as the S&L insurance mess shows, the strength of pressure from cross-industry and global competition is what makes establishing better accountability for Federal supervisory and regulatory performance such a critical task.

The British TV program "Yes, Minister" presents endless variations on a single theme: That in an environment of compromise and accommodation, political solutions mercilessly slaughter principles of good Government.

I urge your Committee to apply, rigorously, to current and future restructuring proposals, the test of whether and how they advance the five principles of good Government enunciated earlier: clarity in goals and policies; transparency of policy decisions and underlying decision criteria; consistent application of policies across institutions and over time; insulation of policies from short-term political considerations; and fifth, and critical to all of this, assignment of potentially conflicting goals to separate agencies.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Let me thank all of you again.

There are a couple of things I want to cover.

I've not run a time clock today because I wanted everybody to have the time to lay this out, and I think what you've all had to say has been extremely valuable.

I want to cut through a little bit of what I think of as the "Fed fog" on this issue. With all due respect to their professionalism, to Alan Greenspan and the others, they are a professional organization, and we have a very fine working relationship with them. But, this issue as to function and domain and consolidation is separate,

in my view, from the question of their professionalism in other respects.

I think a lot of fog has been thrown up here by the Fed, previously, that we really need to cut through to make some sound judgments.

Now, each of you have said, one way or another, that this argument by the Fed that they've got to have this supervisory and regulatory power over the banks, is somehow critically connected to their ability to conduct monetary policy or deal with systemic risk.

I think each of you have now said you don't buy that argument, but I'd like to just go right down the table on that point and have you, in an economy of words, put in your own phrases, your view on whether or not they need this supervisory regulatory authority in order to effectively conduct monetary policy and deal with systemic risk.

Let's just go right down the table with Mr. Longstreth first.

Mr. LONGSTRETH. I've said I don't think they need it. The fact is that they have very little power now over the banking system as represented by banks, as opposed to holding companies. The information necessary to conduct monetary policy, and the information which is somewhat different to deal with systemic risk, is much more vast than would be available to them through supervisory sources anyway.

As to regulation, it has virtually nothing to do with this. So, I think that's the point.

I'd like to just add that if one accepts, as, I think, probably everyone at this table would, Don Howard's assessment that the Fed has been the most conservative, the most reluctant to embrace change, among all the regulators, and if one also accepts the statement you made, and I think we all would, that the Fed is well-meaning and consists of extremely talented professionals, then you have to search for an explanation of why they have been so slow to embrace change to the detriment of the banking industry.

I think the real source for that explanation is the conflicting purposes that they've been assigned to carry out. That is the source of their problem, and that's hurt the banking industry.

The CHAIRMAN. That's interesting.

So, in effect, you're saying that this regulatory and supervisory role has a paralyzing effect on their ability to think more broadly about the banking charter.

Mr. LONGSTRETH. I don't think they have thought deeply about the banking charter in their exercise of supervisory and regulatory authority because they're thinking about other issues: namely, monetary policy and systemic risk.

The CHAIRMAN. Mr. Howard.

Mr. HOWARD. I absolutely agree with Bevis on that. I think the Fed has all the tools it needs to conduct monetary policy, aside from regulatory powers. It's got all it needs.

I think it's asking for regulatory power is a little bit like Norman Schwarzkopf, as he looks at his Desert Storm troops saying, you know, I've got this many tanks, I've got this many airplanes, I've got this many battleships and aircraft carriers, and then turning to his aide and saying, I need my 45 before we're ready to go to battle.

The CHAIRMAN. Mr. Petty.

Mr. PETTY. I would just endorse what's preceded me and say that your best argument, sir, is the examples of situations that have nothing to do with bank regulational failures and that the Fed has intervened very successfully in providing stability to the currency.

I gave the examples of Drexel Burnham, the Ohio failures, Penn Central, and the currency crises. The Fed has the tools, and it uses them effectively. And it's not bank regulatory related.

One last point. The Fed has these dual responsibilities, regulation and monetary policy. Clearly, monetary policy is first and foremost and with that, preserving their independence. There's a political dimension to that, too. Everything else, regulation, etc., is sixth or seventh on their priority list.

The CHAIRMAN. Mr. Sandner.

Mr. SANDNER. It's hard for me to accept the validity of the argument of the Federal Reserve—notwithstanding, as I said before, the admiration I have for Alan Greenspan. First, if the numbers are correct, the Federal Reserve is only supervising 18 percent of the assets—7 percent of the institutions. Two, the Fed is deriving a lot of information from other banking entities and regulators. And, three, the Fed is going to be a part of the Federal Banking Commission, so it is going to get the necessary information.

If information is what helps them decide monetary policy, there is going to be an abundance of information. I propose we ask Alan Greenspan and the Fed, "What information do you need more than what we've already given you? Tell us." When the Fed responds, perhaps it will be easy to give it exactly what it needs.

The CHAIRMAN. I think that's a brilliant question, and I think that's the question that punctures their argument. They don't want that question because it strips everything else away. Because you're quite right. They, in a sense, have the information now. They can have all the information they need.

I think the decisions they make are not being driven by their breaking out of the regulatory functions they have. I think that's a very good way to strip this thing down to its essentials.

Mr. Connell.

Mr. CONNELL. Thank you, Mr. Chairman.

I have very great difficulty in seeing how administration of the Truth-In-Lending laws has any involvement with systemic risk. That's the first point I'd like to make.

The second point is that the Treasury proposal gives the Federal Reserve adequate information, and it also gets information from other sources. It gives it adequate ability to communicate with the other regulatory agencies. It gives it participation in the regulatory process by the seat on the Federal Banking Commission. So, the Federal Reserve is in the loop, and in the loop quite adequately.

Third, nobody likes change done to them, usually, but, I believe, that while the Federal Reserve might have to do things a little differently, they're going to do them with many of the same people actually. I think the credit function will employ a certain number of the people that were in the examination function before, but they're going to be better focused. They're going to be focused on the exposure to the Federal Reserve's resources as well as the market, and they're going to make the decisions in a sharper fashion, undis-

tracted by other regulatory issues that may be floating around at the time.

The CHAIRMAN. Mr. Kane.

Mr. KANE. I echo the sentiments that have gone before me. The economics of the Fed's argument, that it has to have regulatory and supervisory power to conduct monetary policy and to control systemic risks and potential crises, just doesn't float.

This claim is simply scare tactics. Such tactics have served the Federal Reserve well in the past in fending off attacks upon its bureaucracy. We have to remember that the Fed is, looking at it observationally, an enormous bureaucracy. And, as a bureaucracy, it craves turf.

This is not to say that this bureaucracy does not do its job for the Nation as well as it can. That is the prime focus of its ever-changing leadership. But, just below this leadership, I think, are people very worried about the long-term status of the Fed as an organization. Protecting its turf has become the prime objective for them. This concern has distracted the leadership's attention from the dynamic needs of the industry and sometimes even from needs of the larger economy. It's made Fed officials a little slow to move, in response to internal criticism that a mis-step might be punished by a loss of turf.

Turf concerns have distorted Fed performance in supervision and regulation. I agree with the others, that Fed officials have done a relatively laggard job in supervision and regulation. They come to understand what the market has done a year to a year and a half late.

The CHAIRMAN. I just asked the staff if we know what the size of the staff of the Bundesbank is, going back to the earlier reference. We're fetching that number. We may have to put it in the record.

Mr. PETTY. Much smaller.

The CHAIRMAN. It's much, much smaller.

Does anybody know the approximate figure? It would be dwarfed by the scale of the number of people working for the Federal Reserve.

Mr. PETTY. I'd make a comment, sir, too. I think that the Treasury proposal has made more compromises with the Federal Reserve than the merits of the case requires, though it may be necessary for political reasons, as Mr. Bennett reminded us. But, on the merits of the case, Treasury has already leaned over pretty far backward.

The CHAIRMAN. I'm concerned about that because the other question I wanted to pose to you is that maintaining the status quo is not cost-free. We've talked today about some of the costs, but I think there are some even bigger risks than just the waste of resources and the impact on the broader economic vitality of the country. That, to me, is a very material issue.

It seems to me, if we miss this opportunity and we just drift down the road, as is, with this balkanized, overlapping, inefficient structure, it may be several years again, before we get back to it.

You've got to get the stars in alignment. You've got to get a Treasury Secretary that's willing to get out and lead and take on some of the mythology. You've got to have a Chairman of this Com-

mittee that's willing to do it, and you've got to have top-flight professional experts and observers like yourself, who are willing to come forward and puncture these myths and put themselves on the line to do so.

And the press has to pay attention. They have to sort these arguments out and get past the gorilla dust that gets thrown up here by the Fed, and really take a hard look at what's involved.

I think you've provided a lot of insight today. My sense is that if we just drift down the road the way we have been, for another decade, that there are some other risks here that we ought to put on the table.

The status quo is not a cost-free course open to us. How would you describe those, Mr. Longstreth, if we just leave this in place for the next decade?

Mr. LONGSTRETH. Other people have alluded to it, as I have in my testimony. I think the competition now is global and it's a competition not only among the players who are out there trying to make money or reduce risk or hedge or whatever. It's a competition among cities and countries and their regulators to build the best system of regulation, by which I would mean the least-cost system, to assure the minimum amount of regulation that's necessary to meet problems not handled by competition, vibrant competition.

The cities and countries of the world are competing furiously to attract business. So the costs to our country and to our cities, including New York City, where I come from, of failing to rebuild our system of regulation in a sensible, cost-efficient way, the cost to the country is very great, and, I think, it's totally ignored—not totally ignored, but, for the most part, ignored by those here and in Administrations over many years, based on the confidence we have that we are the best and so preeminent that we don't need to worry about what's going on elsewhere in the world.

But, as the super-highway of information and communications continues to build, it's very easy for Goldman Sachs or Morgan Bank to move their center of operations elsewhere and still reach every corner of the globe in their business dealings.

That, I think, is the biggest risk that we face by just fiddling around with a system that is a result of history and not logic.

The CHAIRMAN. Mr. Howard.

Mr. HOWARD. Mr. Sandner talked a fair amount about the pace of change and the acceleration in the financial services world. That's real and it is accelerating.

The internationalization is a fact and the failure to respond to tomorrow's problems with yesterday's solution is going to be very painful to us in the future. If banks are not able to compete for capital, the banks will decline and the economy will worsen.

And the banks must be profitable to attract the capital they need to expand and do things into the future. If they are not able to do that, if they are constrained by regulation from doing these kinds of fascinating, new, and very profitable and exciting things, which they're better equipped to do than most others, they will decline as a factor in the United States, and the rest of the world will take over that role.

The CHAIRMAN. Mr. Petty.

Mr. PETTY. The continued diminution of the role of the banks would be the cost. Constraints, limiting managers' responsibility to react to the marketplace developments. Where were they 2 years ago, 3 years ago? Not as responsive, not as competitive as they might have been or they should be.

The CHAIRMAN. If I may just interrupt, it's very interesting. We've got a proposal we're going to bring to the Senate floor within the next week or so, as things are now scheduled, to securitize business loans by banks, which, in a sense, is a hybrid response to precisely what we're talking about.

We're talking about the fact that the banks, in order to get more capital out to let our free enterprise system work, have a chance to function in this country, in cities, and elsewhere. We're going to help the banks by, in a sense, connecting them to markets beyond themselves so they can originate loans and securitize them and get them out to a place where, in effect, there's a more robust access to capital.

Mr. PETTY. You touch a sore point and a tender issue with me, sir.

Ten years ago, my bank and I innovated securitizing automobile receivables passed through into the marketplace. We were the first one that did it. And that was originally created by my bank. We then wanted to be co-manager of those funds, selling it. That brought us into the securities laws and a violation. We got sued by the Securities Industry Association. The things we invented, created, and originated ourselves we were not allowed to bring to the marketplace and share the managing fee.

Mr. SANDNER. Senator Riegle, I agree with the panelists, but I would like to use our industry as an example of what can happen when Government is not responsive.

First of all, about 12 or 15 years ago, there wasn't another exchange like ours outside of North America. Today, there are about 65 derivative exchanges, and they are not 65 insignificant competitors. For example, LIFFE, in London, which was created about 10 years ago, is now the second largest exchange in the world—in terms of open interests.

I told you that the CME's open interests stood at 6,300,000 contracts. The next largest domestic exchange is the Chicago Board of Trade, with about 2,300,000 open positions. The LIFFE in London has about 4 million open positions. The MATIF in Paris holds about 2.5 million open positions. Next in line is the Singapore International Monetary Exchange.

These international exchanges have grown by copying our concept. Fine! That's competition.

Unlike U.S. exchanges, our foreign competitors don't have to go through a regulatory approval process. When we create a product, we have to go through a regulatory approval process that takes 6 months, 1 year, 18 months. Our competitors decide on a new product and say, we'll just list it at LIFFE or MATIF or the DTB in Germany.

I fear that this disease that's in our system of regulation will do what Mr. Petty just said; cause a further diminution of the banks in the United States. They already have. We don't have one bank in the top 25. Citicorp alleges that they might be 25. I don't know.

The foreign banks will get stronger because they can do the things they need to do to compete and to grow. Our banks will shrink to the point that the foreign banks can pick off our banks. You can see the landscape and where that path leads us.

In Chicago, the Harris Bank is no longer owned by a domestic bank; it's owned by the Bank of Montreal. The LaSalle Bank was bought by ABN Amro. There have been bids, we all know, on First Chicago.

Finally, the Continental was purchased by a domestic bank, Bank of America. But the bigger ones swallow up the smaller ones and the bigger ones are going to be the foreign ones if we don't allow our banks in the United States of America to grow and to compete.

You just take that time line down about 10 years, and you'll see a completely different landscape in America in the banking system if we don't do something. Then, the only thing we'll be able to do is protectionist legislation.

The CHAIRMAN. It's so interesting that you use the word "disease." It's the kind of thing, too, at the end of the decade, let's say we stay on this track and we go down another decade, you've got some hollowed-out institutions. There's a certain regulatory deniability.

I mean, the people who, in effect, may well have hastened the demise will, at the end of the decade, be blame-free. They said we did our job and we were out there, and it's like how many people can you put on a acre of land. Pretty soon you get enough people on the acre, you can't raise anything because everybody's trampling what's trying to grow.

That's another thing I've learned here, and that is that at the end of the game, the people who run the process can usually do it in a way where, if it blows up or if it's tanked in one way or another, that there's a way to insulate themselves from the responsibility.

So you don't even have that working for you. You don't even have the notion that at the end of the game, that bureaucracy has to tee itself up against the fact that, if something caves in, the responsibility is going to come back and attach to what they did or didn't do.

That's an insidious part of bureaucracy. Once you get down into the bowels of the bureaucratic governmental institution, you can't get hold of anything. And so, at the end of a period of time, a decade or whatever, people go on their way and whatever has been accomplished or not done properly, is left behind.

It seems to me we've got an awfully strong case on the table here to wake up and bring ourselves into the late twentieth century and get ready for the next century, so we're not backing into it but going into it straight on.

Mr. SANDNER. You honed in on accountability, which is a very critical issue. Sometimes it is brushed aside, when we look at the problems of the regulatory process.

The CHAIRMAN. Ten years from now, I would predict right now, there won't be a single member of the Fed Board still on the Fed Board. They'll all have gone off to whatever end.

So they're not going to have to live and carry the weight of what they did or didn't do at this particular time, especially in an area like this, which is more arcane.

Mr. Connell.

Mr. CONNELL. The longer regulatory adjustment lags the market, the more costly it is to the market, whether it's reg Q and adjustable rate mortgages, in the case of the S&L industry, which ended up, although resisted by the industry, itself, and the agency, it ended up destroying the industry, among other things.

The same holds true with Glass-Steagall and the efficiencies that are now lacking or the potential efficiencies lost in the securitization of loans and the other provision of services to the public.

The same is true with McFadden and branching and the inefficiency of having to use holding companies over State lines to operate, again bringing the service to the public inefficiently. It could mean jobs if the exchanges aren't properly regulated. That business can move overseas. That's a global business. That means jobs of all sorts in the United States.

The same holds true for the structure of the regulatory agencies. The longer it continues, today, the way it is, the more costly it's going to be to the public directly, in salaries and other administrative expenses. Even more costly than the burdens on the institutions themselves, and more costly in terms of the cost to the general public with the lack of innovation and progress as markets change.

The CHAIRMAN. Mr. Kane.

Mr. KANE. Mr. Chairman, you compared the Fed to the "Wizard of Oz." To illustrate the consequences of keeping the Fed in its conflicted role, I would like to cite another work of children's literature, "Humpty Dumpty." All the King's horses and all the King's men couldn't put Humpty together again.

Suppose the pace of globalization and the technological change that's driving it lasts for another decade and the Federal Reserve continues to sacrifice its supervisory responsibilities to larger purposes.

We are going to move a lot of potential banking business abroad, business that will never come back. This would be sad, given that our Nation has equipped people with human capital and financial capital in enterprises that we needlessly handicap.

Technological change outmodes regulatory rules. It supports the circumvention of inherited rules and forces regulators either to make a reasonable adaptation or to see their regulatees' business go elsewhere.

If an industry's regulators are not motivated to make as apt a response as the parties they regulate, then the industry will shrink.

What disturbs me, on the point of accountability, is Fed presumptions of near-infallibility. I cannot remember any case where Fed officials have either taken blame for their slow hand or admitted any supervisory failures.

Take the case of the Hunt Brothers' silver speculation. I'm sure your Committee held hearings on this. I looked at the case, briefly, a long time ago. But as I read it, Fed officials, honestly, thought

they had done a wonderful job. Yet, their response to this situation was fraught with questionable actions.

The CHAIRMAN. BCCI, a recent example of that, falls right into the regulatory area.

Mr. KANE. Again, I haven't studied Drexel Lambert, but Fed officials all but break their arms patting themselves on the back for that one.

The CHAIRMAN. Let me say to you, again, how much I appreciate the time and thoughtfulness that's been expressed here as well as all the professional years and decades of wisdom that you've brought into the Committee room today.

As Chairman, I appreciate that. I appreciate the fact that we can have this important set of presentations and build a record that really has some weight to it in terms of the quality of the points that have been made, and the experience and the expertise each of you bring.

I think the Fed has put forward an unsustainable position here. I'm going to do everything I can, constructively, to try to move them off that position, because I think it's in the public interest. In fact, I think it's in their own interest to be willing to accept the kind of rationalization and streamlining that's needed here.

I think, in fact, they'd be able to do a better job on the things that they really need to concentrate on: monetary policy, the payment system, and issues of systemic risk.

We've got other people that can go out and do the supervisory and regulatory function and the Fed can have access to that information on whatever basis they want. They can have it all.

In fact, if they're on the Commission, they will have it all and will have it whether they're on or off the Commission. They can have it on a real time basis. We know we can array this information anyway anybody wants it and have it available.

So we're going to press very hard there, because I think the Fed has a responsibility that's bigger than just to itself and just to it's history and the hubris. I think the responsibility here is to accommodate these broader market needs and to be willing to adjust to these realities.

I don't view this as an unfair impingement on their ability to function. To the contrary, I think this is something where they have a large contribution that they can make by showing a willingness to think anew here, and help us accomplish an orderly rationalization of the system.

I hope they'll see the wisdom of that position. I think it would be very helpful to the country and very helpful to them.

Thank you all very much. The Committee stands in recess.

[Whereupon, at 12:25 p.m., Wednesday, March 9, 1994, the Committee was adjourned, subject to call of the Chair.]

[Prepared statements of witnesses follow:]

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Mr. Chairman, I commend you once again for convening this series of hearings on regulatory consolidation. I join you in welcoming today's panel of expert witnesses and look forward to hearing their testimony.

Consolidating the bank regulatory agencies would go a long way toward modernizing our financial system and advancing "good Government." Mr. Chairman, as I stated during the previous hearings on this subject, I intend to work closely with you to enact legislation that would consolidate the bank regulatory agencies.

Streamlining bank regulation would not only provide meaningful regulatory burden relief for banks, it would also make U.S. banks more competitive. One of today's witnesses, former Chief Financial Officer of Citicorp/Citibank, Donald Howard, provides the most vivid illustration of just how far overburdensome bank regulation can go. Although Citicorp represents a complex corporate structure, according to Mr. Howard's testimony, Citicorp had to respond to at least *seventeen* regulators on a regular basis.

Mr. Chairman, this amount of regulation is absolutely ludicrous for any institution—no matter how complex the structure. Mr. Howard's testimony provides an extreme example of overregulation—but it is a real life example nonetheless.

Mr. Chairman, it is distressing that there continues to be disagreement between the Federal Reserve and the Treasury Department on how to proceed with regulatory agency consolidation. They should continue to work together, however, to come to a consensus so that our attempts to consolidate the regulatory agencies do not become the casualty of a turf battle. Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR CAROL MOSELEY-BRAUN

Mr. Chairman, the issue before the Committee today, regulatory consolidation, is an important one, one that needs and deserves our attention. We have a distinguished group of witnesses testifying this morning, and I look forward to hearing their comments and recommendations.

At the outset, I would like to note that one of the witnesses hear today is Jack Sandner, the chairman of the Chicago Mercantile Exchange. Jack Sandner has thought about regulatory issues for a long time now—he is a real expert in this area—and he has made what I think is a very innovative and thoughtful proposal.

I would like to take just a moment to highlight for the Committee one part of Mr. Sandner's prepared testimony. In his remarks, he points out that: "The problem in the Federal financial regulatory structure is not confined to the fragmented regulation of banks." He then goes on to note that, "The simpler world that justified institutional regulation [regulating each type of financial institution separately] has given way to a far more complicated milieu where distinctions among financial institutions have blurred to the point of eradicating the differences and overwhelming the institutional approach to regulation."

I could not agree more! That is why I have introduced S. 1744, legislation calling for a comprehensive review of Federal policies governing our entire financial system from the viewpoint of our economy as a whole, and from the viewpoint of the users of our financial system, the businesses, consumers, farmers, and others who depend on the system to meet their capital and other financial needs.

I want to reiterate that I do not believe that S. 1744 ought to be viewed as a substitute for taking action in the bank regulatory area now. Like a number of other Members of this Committee, I have called on Chairman Greenspan of the Federal Reserve and Secretary Bentsen of the Treasury Department to sit down together and work out a set of compromise recommendations that would resolve the controversies that have emerged with respect to the Administration's original recommendations, and that would permit this Committee to move forward rapidly.

However, as Mr. Sandner's testimony so eloquently states, the banking regulatory structure is only part of the problem. I think S. 1744 will help give us the kind of framework we need to take on the rest of the regulatory problems, and the myriad of other major policy issues that so need to be addressed.

PREPARED STATEMENT OF BEVIS LONGSTRETH

FORMER COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION;
PROFESSOR, COLUMBIA UNIVERSITY SCHOOL OF LAW, NEW YORK, NY

Introduction

My name is Bevis Longstreth. I am a partner at the law firm of Debevoise & Plimpton. This year I hold an appointment to the faculty of Columbia Law School as Visiting Professor of Law from Practice and will be teaching a new course in the regulation of financial intermediaries. I have practiced in the banking and securities fields for more than 30 years and served from 1981 to 1984 as a Commissioner of the Securities and Exchange Commission. I come before you with no special interest linked either to my law firm or any of its clients. For the simple reason that they make good sense, I support the Administration's proposal for consolidation of the bank regulatory agencies and the legislative proposals to the same general effect introduced by Members of this distinguished Committee (collectively called "consolidation" or "consolidation proposal"). I am responding to your invitation to testify to this effect because, even upon reaching the seventh decade of one's life, when cynicism about many things, including the ways of Government, is expected to reach its zenith, I still believe governmental change for the better is possible, that the British philosopher, F.M. Cornford's quip that "nothing is ever done until everyone is convinced that it ought to be done, and has been convinced for so long that it is now time to do something else" can be proved wrong, at least when the case for change is as clear as has been presented to this Committee.

My testimony is divided into three parts: *first,* a brief explanation of why I support consolidation; *second,* an explanation of why it would be unwise to effect a consolidation of bank regulatory agencies into the Board of Governors of the Federal Reserve System ("FRB"); and *third,* an answer to the principal arguments against consolidation advanced by the FRB.

I. The Case for Consolidation

Consolidation would create a single independent Federal agency, the Federal Banking Commission ("FBC"), to supervise and regulate the banking and thrift industries, thereby consolidating into the FBC these functions as exercised by four Federal agencies (*i.e.,* the Office of the Comptroller of the Currency ("OCC"), the Office of Thrift Supervision ("OTS"), the Federal Deposit Insurance Corporation ("FDIC") and the FRB). Consolidation would reorganize the Federal banking agencies around three core functions: deposit insurance, central banking and supervision/regulation. The FDIC would continue to insure deposits at banks and thrifts. The FRB would continue to conduct monetary policy, administer the payments system and respond to systemic crises. And the FBC would be charged with supervisory and regulatory responsibility for all FDIC-insured depository institutions and their holding companies.

There is much common ground in criticizing the present system of Federal bank supervision for its unnecessary cost, incoherence, confusion, and lack of accountability. Indeed, the need for reform generally along the lines of the consolidation has been widely recognized for at least 55 years, beginning with the so-called Brookings Report in 1939, which advocated just two agencies, one, the FRB, for monetary policy and credit, and the other, the FDIC, for insurance and supervision over all insured banks as well as their holding companies and affiliates.

The annual cost savings to be derived from consolidation have been estimated by the Administration, drawing on, among other things, a 1992 study headed by FRB Governor, John LaWare, at $150 to $200 million saved in agency regulatory cost and another $3 to $4 billion saved in industry compliance cost. This dollar cost, while large, doesn't address the major cost to banks of delay in obtaining approval for product innovation and expansion. While hard to quantify, this cost under today's regulatory system is very large. If the FBC acts effectively with respect to its sole purpose—the safety and soundness of banks over the long term—this cost should become a well deserved casualty of consolidation.

The Administration's concern over regulatory cost is well placed. Cost matters, and increasingly so into the future. That the financial markets have become global is today a commonplace. This truism means, among other things, that competition among many countries and cities to capture a fair share of the world's financial business is not only possible but occurring with ever-increasing zeal. As technology inexorably continues to reduce the costs of relocation, the regulatory burdens faced by banks and other financial institutions in electing to conduct business in any one of the growing number of alternative jurisdictions become increasingly important. Yet the United States is virtually alone in traditionally debating regulatory, tax and

other conditions affecting the banking industry with little reference to the potential consequences they hold for the industry's ability to compete internationally. The easy assumption of our Nation's preeminence, built up in the early post-World War II years, has made it difficult for our national policymakers to recognize that domestic regulatory structures serving parochial interests can undermine the strength of our banking industry in the increasingly competitive global market.

In other words, if the U.S. regulatory burden becomes too great, in comparison with that of other world-class financial centers, the much talked of information super-highway will carry financial business away from our shores. One need only recall the creation of the Eurobond market in the early 1960's, attributable to the Government's attempt to deal with the balance of payments' problem through an interest-equalization tax, to appreciate the potential for large-scale migration of financial services business offshore. And, it is important to note that, once established, the business lost to London in the early 1960's, never came back. By 1986, dollar-denominated Eurobond volume had surpassed U.S. domestic corporate bond volume.

Beyond the matter of cost, it seems obvious that a single Federal agency for supervision and regulation will go a long way toward the removal of the incoherence, confusion and lack of accountability with which our present system is afflicted. These points have been forcefully presented to this Committee, and I shall not repeat them.

II. Why Not Consolidate into the FRB?

Consolidation into the FRB (or for that matter the FDIC) would be feasible, and presumably would achieve many of the goals of the proposed consolidation, including reduction in cost. Indeed, instead of ending up with three Federal bank agencies, there would be just two. If I had to choose between such a consolidation and what we now have, I might well elect consolidation. However, there are strong reasons, rooted in conflict of purpose, that make the proposed consolidation a far preferable alternative.

Conflicts exist now at both the FRB and the FDIC because each combines the supervisory and regulatory functions with a very important and highly visible function that can and does, from time to time, conflict with its role as supervisor/regulator. The attractiveness of the consolidation proposal is that it would eliminate these conflicts; the problem with consolidation into the FRB or FDIC is that it would exacerbate them. Since the FRB has proposed a reshuffling of agency responsibility that would substantially increase its powers of supervision and regulation, and since I'm aware of no suggestion to consolidate into the FDIC, I will only address the conflict problem at the FRB.

The FRB's dominant responsibilities center on the conduct of monetary policy and, as lender of last resort, the management of systemic crises. These duties command the interest and attention of the Governors and of top management of the regional Federal Reserve banks, to a degree far exceeding their involvement in the FRB's supervisory and regulatory roles. For this reason, in the event of a conflict between the goals of monetary policy (stable growth of the economy without inflation) or avoidance of systemic crises, on the one hand, and the goal of supervision and regulation (safety and soundness of the banking system), on the other, the FRB would be expected to, and does, use its powers of supervision and regulation to serve those broader goals, sometimes at the expense of the safety and soundness of depository institutions. Chairman Alan Greenspan's testimony of March 2, 1994, acknowledges this point by suggesting that supervisory and regulatory powers give the FRB the "clout" necessary to address systemic risk and to see to it that broad economic factors are considered in rulemaking.

In addition, the FRB uses its supervisory and regulatory powers to preserve its independence in the conduct of monetary policy, a feature of its operations long cherished not only by the institution itself but a very broad consensus of the American public. Thus, its regulatory powers have been used, by way of "carrot" and "stick," to assure the support of a large constituency (bank holding companies and State-chartered member banks) and to avoid political controversy that might, in its cautious view, imperil its independence.

Whatever one may think of the possible benefits to monetary policy and avoidance of systemic risk from allowing the FRB to use its supervisory and regulatory duties in fulfilling those larger goals, it hasn't always produced sound supervision or regulation. As the much quoted J.L. Robertson, a former Vice Chairman of the FRB who Carter Golembe described as one of the Nation's outstanding authorities on bank regulation, said in recommending that bank regulatory authority be transferred from the FRB to an independent agency:

> The overriding reason, however, for seeking to have the supervisory powers vested elsewhere than in the Federal Reserve is my deep-seated conviction that

bank examiners should always be free to call the pitches as they see them. They should be insulated from any possible temptation of the monetary authority to use supervisory powers to implement monetary policy by appraising loans with a more critical eye in periods of tight money, when monetary policy is seeking to curb credit, and a less critical eye in periods of easy money, when the aim of monetary policy is to expand the money supply.

There have been numerous examples of these conflicts over the years.

- In 1973, FRB officials used personal contacts to persuade banks to hold back prime rate changes dictated by market forces set in motion by the FRB's own open-market operations, thus putting at risk the safety and soundness of those banks that complied.
- In 1986, foreign banks seeking to acquire primary dealers were unduly delayed by the FRB in gaining the necessary regulatory approvals because of political and macroeconomic issues having nothing to do with the safety and soundness of the institutions involved.
- In the late 1980's, the FRB opposed the substantial increase taken by a number of multinational banks in their reserves for loan losses due to the poor quality of loans to lesser-developed countries, out of a fear that it might disrupt relations between Third World Nations and the international financial community.
- The FRB has been resistant to efforts by banks and their holding companies to obtain broader powers which the FRB thought would detract from its ability to conduct monetary policy, either by weakening its regulatory grip on the banking industry or bringing it into political controversy inimical to its independence. Examples include: *(a)* in the 1970's its refusal generally to permit bank acquisitions of thrifts and to permit the tandem operation of those (usually in failing situations) whose acquisitions were approved, thereby preventing a private sector mitigation of the S&L risk that grew so large thereafter; *(b)* its attempt to extend insurance restrictions to bank subsidiaries of holding companies and operating subsidiaries of State-chartered bank subsidiaries of holding companies engaged in municipal bond enhancement activities functionally equivalent to the use of bank letters of credit; *(c)* its unnecessarily narrow interpretation of "principally engaged" under section 20 of the Glass-Steagall Act for purposes of allowing nonbank affiliates of bank holding companies to underwrite and deal in securities; and *(d)* its unnecessarily narrow definition of "bank-eligible" securities activities for purposes of section 20.
- The FRB's conflict of purpose is actually embodied in FDICIA, which contains an exception to the regulator's obligation for prompt closure of insolvent banks, giving to the FRB specific power to assert significant influence against closure.

Of course, one might argue that supervisory and regulatory powers are necessary to assure the FRB of its independence, which in turn is vital to the conduct of monetary policy, and that, accordingly, these powers must be subordinated to the broader goal where conflicts arise. Although I doubt such a case can be made (the FRB being too modest about its power to retain independence, which is by now as ingrained in our polity as family values), I would have an open mind on such a proposition. Thus far, however, the FRB's arguments against consolidation have not been advanced along these lines. Instead, the FRB has put forth several other arguments that, when examined, do not hold up.

III. The FRB's Arguments Against Consolidation

The FRB's principal arguments against consolidation turn on its claim that supervision and regulation are essential to the effective conduct of monetary policy and dealing with systemic risk.

Given the very limited scope of the FRB's direct responsibility over FDIC-insured depository institutions (7 percent) and assets (18 percent), it is hard to see how supervision and regulation can be essential to the conduct of monetary policy. The FRB must, and does, rely on examinations and reports conducted by the other Federal bank agencies with respect to most of the banking industry. Moreover, the banking industry, itself, is a shrinking part of the total financial system, representing only about one-third of total assets in the financial services industry. The FRB meets its need for financial information necessary to the conduct of monetary policy from myriad sources, most of which relate to institutions not subject to its supervisory or regulatory powers.

It is equally difficult to find warrant for the claim that its powers to supervise and regulate are necessary to the FRB's effective management of systemic crises. Because of the eroding importance of banks within the financial system, the source of systemic crises, more likely than not, will be found among other types of financial institutions, of which Drexel Burnham is one recent, notable example. The passage

of FDICIA significantly increases this probability. Indeed, it was for this reason that Congress included in FDICIA language expressly authorizing the FRB to use its powers as lender of last resort to come to the aid of nonbanks as well as those having regular access to the discount window.

Moreover, according to the Treasury, in most of the highly developed countries, the central bank's regulatory role is subservient to that of the Ministry of Finance or Treasury. For example, only four of the 12 Basle countries have elected to give their central banks primary responsibility for bank supervision.

Other arguments made by the FRB center on the notion that affording depository institutions a choice among two or more regulators provides a necessary set of checks and balances to regulatory oversight, thereby enhancing effectiveness.

There is something seriously wrong with the idea that a competition among Federal regulators, fostered by affording those regulated a continuing choice of regulator, is either necessary or desirable to achieve the proper goals of regulation, which in this case are safety and soundness of banks. There are plenty of checks and balances embedded in our system of Government through the Constitution. Congress writes the laws deemed necessary to carry out public policy. They are accountable to the electorate, as is the President who signs those laws into effect. Regulators implement those laws. They are appointed by the President, confirmed by the Senate and have limited terms. They are strictly accountable to the Congress, and subject to review in court, for the proper implementation of those laws. At a time when many citizens are questioning the effectiveness of Government, and suggesting the costs imposed on them to pay for Government far exceed all benefits achieved, it is stunning to read the Chairman of the FRB declare that duplicative Federal agencies are necessary to assure that Government does its job well. On its face this is a silly claim, but it's pernicious too in furthering the distrust and disrespect for Government that has grown up in recent years. Beyond theory, fortunately, one can point to many examples of effective regulation by single agencies. The SEC is one and the FCC is another, to mention only two.

The FRB says in its testimony that multiple regulators create "an invaluable restraint on any one regulator conducting an inflexible, excessively rigid policy." But bank holding companies have no choice of Federal regulator—only the FRB. Presumably, the FRB would not apply its argument for dual regulators to the regulation of bank holding companies. Nor would it allow such an argument to cast doubt on its own handling of what are "monolithic" responsibilities in regard to bank holding companies.

The FRB also argues consolidation will harm the dual banking system. This system afforded a bank the choice of either a Federal or State charter and, thus, a choice between the different bank powers that, prior to FDICIA, often existed between State banking systems and the Federal system. Now, with FDICIA, State-chartered banks generally can not exercise powers as principal that nationally-chartered banks can't exercise, reducing very significantly the importance of choice in chartering. To my understanding, the dual banking system has never meant, as the FRB suggests, that the "availability of a State charter carr[ies] with it the choice of Federal regulator." The only choice now is between the FRB, if the State bank is a member of the Federal Reserve System, and the FDIC, if it is not. The decision to be a member or not turns on many business factors unrelated to the attributes of these two Federal regulators.

The FRB also claims a single regulator may prove more risk adverse than would multiple regulators competing for business, who could be expected more effectively to foster product innovation. My experience at the SEC has convinced me, beyond doubt, what should be obvious to any close observer of the financial scene: Innovation occurs in the marketplace, among competitors, not around the regulator's table. The SEC's task, and a challenging one at that, is to try to keep up with an explosive creativity in the marketplace it regulates. And this is all one can expect of the SEC. It is not charged to innovate, nor does it do so in fact. Regulatory change occurs because those competing in the marketplace demand it. The same is true for bank agencies.

Moreover, as noted at the outset of this testimony, globalization of financial markets has generated vibrant competition among countries and cities for market-share, bringing sharply into focus the comparative advantages and burdens of different systems of regulation.

One final point on the FRB arguments. The FRB is seriously conflicted in regard to the consolidation proposal, because it stands to lose the very considerable power of supervision and regulation over bank holding companies, in whose banks more than 90 percent of all bank deposits are held, and to lose the need for a large segment of its staff. Carter Golembe estimates conservatively, based on the FRB Annual Report: Budget Review for 1992–93, that the number of FRB staff assigned to

(or budgeted for) bank supervision and regulation is roughly three times greater than that assigned to monetary policy (3,304 to 1,212).

Since consolidation poses a threat to the FRB's regulatory power over banks (exercised mainly through their holding companies) and to the size of its staff, it is not surprising that the FRB stands against the proposal. These conflicts make it highly unlikely that the FRB can bring to the debate an entirely dispassionate and objective eye. They should also make the Congress cautious in giving weight to the FRB arguments without the most rigorous and skeptical probing.

PREPARED STATEMENT OF DONALD S. HOWARD

Former Executive Vice President and CFO, Citicorp/Citibank, Salomons, Inc., and Salomon Brothers; Independent Consultant, Atlantic Highlands, NJ

Summary

In my 36 year career in commercial and investment banking, I have had extensive and intensive personal exposure to banking and thrift regulators at all levels. On the basis of my experience I believe:

1. Bank regulation focuses on two factors:
   A) Examination of bank operations
   B) Approval authority for mergers, acquisitions, and new and expanded powers

I believe that a single regulator for all banking functions is far preferable to the present unnecessary and costly duplication of regulatory functions.

I also believe that the Federal Reserve, in exercising its authority to approve new and expanded powers, has been slow to permit banks to respond to significant changes in markets. The result has been a significant negative impact on the ability of the U.S. banking system to compete in an ever-changing world.

2. The Federal Reserve has today sufficient and very powerful tools with which to monitor the financial health of individual banks and of the banking system as a whole and does not require regulatory powers to execute monetary policy.

Testimony

I appear today as a private citizen, representing no one but myself. I am not an officer or director of any financial institution. At year-end 1993 I retired after serving as Chief Financial Officer of Salomon Inc. and Salomon Brothers for 5 years following my retirement from Citicorp/Citibank in 1988. I was employed by Citi for 31 years, starting in 1957; I currently receive a pension from that institution.

For the past 40 years I have been connected with financial institutions, as a student, as an academic, and as an employee. At Citi, I had direct contact with bank regulators for over 30 years, first, as a bank lending officer and supervisor of overseas branches; and, for 15 years commencing in 1973, my primary responsibilities included supervising the management of Citi's day-to-day relationships with all bank regulators.

Based on my experience, I strongly support the concept of a single regulatory agency for each organization performing banking functions in the U.S.

Bank supervision has two quite distinct aspects: first, authority to examine all aspects of bank operations; and second, authority to approve mergers, acquisitions, and new or expanded powers. In my view, establishing and executing monetary policy has almost no connection to bank examinations.

I feel very strongly that the power to examine banks should be vested in a single regulator. The current duplication of functions is costly, wasteful, and unnecessary. This duplication has evolved over time as financial services and financial markets have developed to accommodate changes in the public's real and perceived needs. Limiting the financial services which any one institution can provide is less and less relevant to the American public, which is becoming increasingly comfortable with obtaining banking services from brokerage firms, investment services from commercial banks, and insurance services from savings banks. In response to legislative requirements, Citicorp, a bank holding company, had within its very complex corporate structure at least one of each of the following: National bank, State bank, Edge Act bank, nonbank bank, thrift, and nonbank activities. Citicorp, the parent bank holding company, was regulated by the Federal Reserve. Citibank was regulated, ostensibly, by the Office of the Comptroller of the Currency (OCC). These were the firm's two primary regulators but, because of the business conducted by one or more entities within the Citicorp legal structure, Citi had at least *SEVENTEEN* different regulatory bodies to which it responded regularly. These included the Federal Reserve Board, five regional FRB's; the OCC in Washington and New

York; the Federal Home Loan Bank Board (now the Office of Thrift Supervision) in Washington and four regional FHLB's; the FDIC and the now-defunct Federal Savings and Loan Insurance Corp; plus, at any one time regulators in at least two States.

Each of these regulators believed it was necessary for it to review the condition of the parent bank holding company, consolidated Citicorp, in addition to examining those entities for which it had direct supervisory responsibility. The logic was to ensure that the parent Citicorp was a source of strength to the subsidiary not a potential drain on the subsidiary's resources. The Fed also took the view that it had to examine/review Citibank using the logic that its financial condition was critical to properly assess the financial health of the entire Citicorp organization. I believe there was justification to all of these views. Each of the regulatory bodies resisted attending discussions/presentations at which other regulators were present. The result was numerous, repetitive discussions and presentations. The regulators were very sensitive to the order in which these discussions/presentations were held. The New York Fed was first. Then to Washington where protocol dictated that the staff of the Fed was first, followed by the Comptroller and then either the FDIC or the FSLIC. The FHLB was usually last. This was then followed by visits to the other regional offices. Again, the Fed was first in any city where there was more than one regulator. To be of value, all meeting had to be held within about 3 weeks of the announcement of Citicorp's quarterly earnings. The scheduling of these quarterly meetings was a nightmare. One meeting with a single regulator would have saved a great deal of time and would likely have produced at least as much information and dialog of real value.

Duplication of examinations may be an ever greater problem for smaller banks which do not have the resources available to larger ones. Three weeks ago I met with the President of a State bank subsidiary of a bank holding company. Both the bank and the parent are moderate-sized institutions. In sequence, this bank has had examinations from the State Bank Examiners, the Fed and the FDIC. Each of the regulators has individually reviewed and classified each of the bank's business loans. They have very few loans to major corporations. Each loan has been reviewed, discussed, and classified three times. There are significant costs to the bank. First, they pay the regulators for the cost of the examinations. Second, both loan officers and senior management are tied up many hours in duplicative discussions with the various examiners and not available to service customers. Third, after all the reviews and classifications are completed, the bank must charge earnings to provide reserves for each loan based on the most severe classification of any one of the regulators. The result is that the loan loss reserve against the entire portfolio is higher than any one of the regulators would have required. Because these charges flow through the profit and loss account of the bank, its earnings are reduced, its capital is reduced and its ability to fund its (mostly small business) customers is diminished. The final and most significant cost of duplication is the time spent by bank senior management and its directors in meeting with each of the regulators separately. The added value of the duplication is diminimus.

On occasion the requirements of one regulator were contradictory to those imposed by another. The resulting need to negotiate between regulators was very time consuming and unproductive. One specific instance comes to mind. Citicorp management developed a plan to increase the capital of Citibank. After discussion with the Citibank's primary regulator, the OCC, the plan was approved by the OCC. But the Fed demanded significant changes to the plan, notwithstanding the fact the OCC was both the primary regulator and had approved. Countless hours of top management time was spent addressing this issue. Jurisdictional disputes (turf wars) between regulators create impossible situations for the banks that get caught in the middle. The result was a significant expense resulting from time spent in totally unproductive activities, but absolutely necessary under the circumstances.

A related issue, but one which should be addressed, is the role in the regulatory process of regional offices of the various regulators. As banks and bank holding companies expand across State lines, they enter the jurisdiction of additional regional offices of the various regulators. Particularly in the Federal Reserve System, the regional banks asserted some independence from Washington and this impact was clearly felt in the extensive time it took to gain approval for new or expanded powers. All such applications had to be sent first to the local regional office. For significant issues that office could only forward their analysis and recommendations to Washington for decision and more delay.

There simply is no justification for the cost of duplicate examinations by numerous regulators. The value added by having numerous examiners review the identical data is minimal. The cost is real and the cost is ultimately paid by bank customers and taxpayers. The information developed by the examiners of one regulator could

easily be shared by all affected parties. To me the logic of a single regulator for this aspect of bank supervision is compelling.

However, I believe that for the regulators this is not the main issue. The authority to approve mergers and acquisitions and new or expanded powers for the banking system is the key issue. It is in this aspect that there has been inconsistency between the regulators. This led to "shopping" by individual banks to determine which regulator was most likely to approve that specific application. Frequently, the decision on which corporate legal vehicle to use for a proposed new or expanded activity was determined by which regulator was judged most likely to approve. In my view, the ability to select a regulator who would say "yes" has been crucial to the progress of the banking system in this country over the last 20 years or so. The OCC and various of the States have clearly taken the lead in this regard. It has been the Fed which has resisted changes. The banking system has not collapsed because banks can now own thrifts, offer investment services or even, for a limited number of very large banks, compete directly with investment banks as underwriters of publicly offered securities. I do see significant risk to the banking system in the agency consolidation proposal. In concentrating the approval power for new or expanded activities, banks could be put at an even greater competitive disadvantage than they are now unless the approving authority is sensitive to changes in the markets for financial services and acts promptly to permit U.S. banks to complete effectively. For banks, I believe, this is either the best of all worlds, if the Federal Banking Commission is responsive, or the worst if it is not. In my discussions with bankers, many would rather deal with the devil they know rather than take the risk of the unknown. The consolidation proposal would not eliminate "regulator shopping" because a State bank alternative would still exist. It should be recognized that as long as there is more than one approving authority for new or expanded powers the result could, and probably will, be an "uneven playing field" over time. The larger banking organizations which have greater resources and flexibility will tend to gain at the expense of the smaller- and medium-sized banks.

It was my experience that the Fed was the least responsive of the regulators in approving new and expanded powers for banks. The Fed always approached new or expanded powers discussions with their own agenda. If the approval would impact, however minimally, its ability to conduct monetary policy or if the approval was likely to create political controversy, approval was not granted at all or, if granted, only with significant delay. Frequently, applications were denied even in the fact of the realities of the marketplace. When Merrill Lynch introduced the Cash Management Account, banks requested the Fed for approval to pay interest on demand checking accounts or, alternatively, to allow checks to be written on savings accounts. The CMA is an interest bearing account on which checks can be drawn. Only after a very long period of deliberation did the Fed permit a limited experiment with NOW accounts in New England, later expanded to the whole country. By the time approval came, the banks had lost important competitive ground which has never been recovered. Another example is the Fed's long refusal to permit banks to own thrifts. This refusal was based on the curious legal logic that the thrift business was "not functionally related to banking." As a result, the thrift crisis was more severe and costly to the American taxpayer than necessary. In my experience, the Fed measures every proposal against the impact on its own independence and its conduct of monetary policy. The long-term impact on the banking industry was always a secondary or tertiary consideration. I attribute much of the relative decline of the U.S. banks in the financial intermediation process in the U.S. to failure on the part of the Fed to grant the powers necessary for banks to compete successfully.

Regulation of banks at the Federal level is unique, I believe, in that so many agencies have some regulatory responsibility for at least a portion of bank activities. Most Federal regulation is concentrated in a single agency—airlines, railroads, communications, television, for instance. Only banking has such a multiplicity of regulators. Determining which bank regulator has jurisdiction is based primarily on the activities or functions engaged in by the particular legal entity to be regulated. But, generally speaking, this is not how banks manage themselves. Most banks are managed by functions, markets, customers, or product types. Several legal entities may offer the same service or products or serve a single customer type. Generally those functions, services, and products are managed on a consolidated basis irrespective of legal entity. The result is a regulatory framework that is focused very differently from the way banks are actually managed. This leads to confusion in the examination process and time consuming expense to adjust internal documents and thought processes to the legal entity focus of the examiners.

Going forward, the examination process will require even greater expertise and experience, particularly in reviewing activities in derivative products. It is more

likely that the higher-level attributes required of the examiners would be found in one agency rather than diluted into two or more.

If the Federal Reserve were removed from the bank regulation process, would it have a significant negative impact on its ability to conduct monetary policy?

My answer is no, it would not.

Perhaps historical analysis might conclude, that the answer to that question should be a qualified yes. But we should be looking forward, not backward. We should be concerned with the future, not the past. The percentage of financial assets in this country held by U.S. banks, now only about one-third of total financial assets, has been declining for a long time, for perhaps two decades. Even if the Fed were to be the sole regulator of all banks, it would still have to rely increasingly on open-market operations, access to the discount window and its central role in the payments' mechanism for successful conduct of monetary policy.

In 1960 I was assigned responsibility for Citibank's activities in the Eurodollar market, which had its beginnings in London; at that time, I supervised Citibank's London operations from New York. From that day until my retirement from Salomon Brothers less than 3 months ago my responsibilities included monitoring on a minute by minute basis, the Fed's activities in all markets. For Citi to be positioned appropriately, it was necessary to know not only what the Fed was doing, but to make an assessment of why they were doing it. Then we attempted to forecast the impact of those actions on various financial and foreign exchange markets. Thus, I speak from over 30 years of experience in the trenches.

In my career there have been four changes in financial markets of such magnitude that, I believe, they are irreversible and have fundamentally changed the way the Fed conducts monetary policy. The four have two common characteristics: first, each resulted in U.S. banks being circumvented in the financial intermediation process; and second, the cause of that circumvention was the requirement for banks in the U.S. to carry reserves against liabilities (deposits in the case of banks) which were not required of other financial intermediaries. Deposit reserves are, in essence, a tax borne only by banks. In chronological order these changes are: (1) development and growth of the Eurodollar market; (2) explosive growth of the commercial paper market; (3) development of the Cash Management Account which led to the incredible growth of money market mutual funds; and, (4) the more recent extraordinary ability of capital markets to securitize bank and bank-type assets.

In the U.S. enormous sums of money are being gathered constantly outside the U.S. banking system and being put to work building houses, financing businesses, and other productive purposes. U.S. banks are increasingly less relevant to the process. These trends are accelerating. The argument that the Fed must be a bank supervisor to execute monetary policy is to me, to ignore the facts. Would it be easier for the Fed if it had bank regulatory power? Marginally, yes—but necessary—clearly not.

The Fed does have powerful tools for executing monetary policy: The discount rate, setting reserve requirements, and open-market operations. They have used these tools with great skill over the years and have accomplished their goals effectively. Open-market operations combined with access to the discount window and a central role in the clearance and settlement process are all vital to the Fed's primary monetary policy role. None of these tools requires direct supervision of banks.

The power to determine access to the Fed's discount window is significant in executing monetary policy. Access is a privilege, not a right. The Fed determines which banks can use the window, for how much, for how long, at what rate and how frequently. If their policy calls for a tightening of money, they reduce the amount they lend to the banks. Increasing market liquidity, to bring down interest rates, for instance, would be executed in part by permitting banks to borrow more. To make this tool even more powerful, I recommend that U.S. Government dealers, who move billions of dollars every day, be permitted direct access to the discount window. This would enhance the Fed's ability to control market liquidity. Also, obtaining information about these movements directly would, I believe, improve the Fed's market knowledge significantly.

Because the Fed requires acceptable collateral for all of its discount window loans, specific knowledge of the condition of any individual institution is not critical to the decision to lend. If a bank needs assistance over an extended period of time, the Fed could, as it could now for those banks which it does not supervise directly, get information on that bank's condition from its primary regulator.

The Fed's role in the payments' mechanism is also critical to its conduct of monetary policy. The Fed is in constant, instantaneous touch with the movement of funds from one institution to another, from one section of the country to another. This is the heart of the U.S. economic body. It is also the source of significant information about the activities of individual banks and their customers. In combination with

access to the discount window, the Fed has detailed knowledge available on the impact of transactions going into and out of every bank which is a member of the Federal Reserve System.

The argument that the Fed needs the power to examine banks to have a detailed knowledge of what banks are doing is not creditable to me. For 15 years I had responsibility for Citibank's Treasury activities worldwide. My signature was also required for all credit Citicorp extended anywhere in the world to any of the world's 50 largest banks. I know from experience that knowing how an institution is behaving in the money, foreign exchange, and capital markets is more timely and a better indication of the health of that institution than a superb analysis of its financial statements. Financial statements—and bank examination reports—are yesterday's newspaper. Knowing how an institution is behaving in financial markets and how other market participants are dealing with them is vastly superior knowledge on which to make decisions on the health of the institution compared with stale financial statements. And that information is available to the Fed in more detail and more quickly than to any other institution or agency. In my view, they do not need additional information sources on individual banks to conduct monetary policy.

In my experience, when the Fed wanted to know anything about what Citi was doing, one of their senior officers called the bank and either asked over the phone or set up an appointment to address their queries. To assert that the phone calls would not have been returned because the Fed did not have regulatory authority seems farfetched to me. When the Fed needed current information on Citi's activities it did not normally utilize its own field examiners as an information source. It was a channel they rarely used and then only for the most routine of items. A bank examiner has knowledge of a bank's activity only as of the last date he/she examined that particular function and that could be months or even years previously. When the Fed wanted current information they asked directly. I see no logical reason for this to change if the Fed were no longer to have regulatory power.

The Fed has acted promptly and effectively in dealing with U.S. monetary crises, most of which have not been triggered by problem banks. I do not believe the Fed would have acted any differently in any financial market crisis in the past 30 years had they not had direct regulatory authority. Providing liquidity to financial markets, making reassuring telephone calls, issuing calming press releases and utilizing their extensive, unexcelled information network to monitor results do not require regulatory powers. Where monetary matters are concerned, bankers do not ignore requests (or advice) from the most powerful financial institution in the world. This has nothing to do with the ability to regulate.

It appears that the Fed is currently focusing its monetary policy more on interest rates, which the banks certainly do not control and, in fact, can only influence slightly on the margin, than on money supply. This appears to be partially in response to the enormity of the changes in financial markets. The changes I described earlier have made the Fed's job of executing monetary policy increasingly difficult and the pace of change is accelerating. To me, the emphasis now should be on determining what tools the Fed will need in the future to do its job effectively rather than assuming that what was useful yesterday will continue to be of equal value in a very different tomorrow. Will the tools now available to the Fed be sufficient for them to carry out monetary policy in the future? I do not know the answer, but I am certain that retaining the power to regulate only a portion of the U.S. banking system is not part of the solution.

It is clear that the primary role of the Federal Reserve is monetary policy. That role is so important that I believe carrying out that function should not be diluted even slightly by having any of its resources diverted to any other function, including bank regulation.

PREPARED STATEMENT OF JOHN R. PETTY

FORMER CHAIRMAN OF THE BOARD, MARINE MIDLAND BANKS, INC.; FORMER CHAIRMAN, BANK HOLDING COMPANY ASSOCIATION; FORMER DEPUTY ASSISTANT SECRETARY AND ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY; CHAIRMAN, FEDERAL NATIONAL PAYABLES, WASHINGTON, DC

The initiative to consolidate all Federal bank regulation within a new Federal Banking Commission addresses key issues and it offers the potential for efficient and improved oversight.

My testimony will be limited to making three points:

1. The legislation should assign to the Federal Banking Commission the explicit responsibility to *advance the national interest by assuring that the banking industry*

is fully competitive in the marketplace and responsive to the commercial and consumer financial needs of the Nation. In other words, the regulators *are not just to assure the safety and soundness* of banks in order to reduce the contingent liability created by deposit insurance. Rather, an additional purpose of bank supervision should be to help assure a competitive banking industry as a feature critical to our economy.

2. Consistent with the above, regulators should evaluate banks as *going concerns* and not just assess their value on a *liquidation* basis. This addition of a second criterion is a subtle point of no small significance.

3. Combining the central bank's responsibilities with bank regulatory responsibility is *not the ideal combination* as expressed by Dr. Helmut Schlesinger, President of the German Central Bank, to which I will refer.

A Competitive Banking Industry is in Our National Interest

Legislation should declare most explicitly that it is in the national interest to have a healthy, responsive, and fully competitive banking industry in order that banks may play an active role in serving the commercial and consumer interests of the country.

This is not addressing the obvious; it is legislating the neglected. To whom did the Nation first look for help in alleviating the recent recession? The uneven response by the banks to this call was a product of things past, and is explained to no minor extent by previous Government and regulatory action and inaction. This can be redressed over time with the influence of a Federal Banking Commission whose statutory mandate is to help achieve a fully competitive banking industry, one responsive to the commercial and consumer financial needs of the country.

The Nation has lacked a timely response by Government to changes in the financial marketplace. These changes have placed demands upon banks whose capacity to respond has been compromised by stale regulations. While substantial thinking at the governmental level has been directed toward "risk limitation," too little attention has been directed at this official level to the implications of the changing marketplace. "What," it should be asked, "is the necessary regulatory response to these changes: Would modifying or voiding ancient regulations enable banks to make adjustments dictated by the marketplace?"

A quick and effective business adaptation to new circumstances is what makes sustained profits—that ingredient essential to corporate life (and Federal tax revenue)—possible. As much as anything else, the shortcomings of the banking industry can be traced directly to the restraints to which bank management is subject, restraints which limit their ability to respond in a timely fashion to the intensely competitive marketplace in which they operate. Slow or delayed regulatory change means a loss of the banks' market share. Regulations conceived under one set of circumstances may lack justification in a changed situation. The Federal Banking Commission should perform its responsibilities in a manner which facilitates both timely and prudent responses by banks to the Nation's evolving business environment.

Sadly, there is no regulatory body that is sufficiently up to date with competitive marketplace dynamics. The economists at regulatory bodies ordinarily require a 3-year regression analysis of statistics before they will commit themselves about particular developments. Today, the life of a financial product is less than half that. The event has arrived and taken hold by the time the macroeconomist addresses it. The unhappy truth is that bank supervisors and the legislation they administer lag so far behind marketplace developments that the banks they limit through regulation slip even further behind.

If legislation assigned the proposed Federal Banking Commission the task of "taking timely actions to help assure the competitiveness of the banking industry," Congress would take a giant step toward redressing what ails the industry.

A Second Criterion for Bank Examination

In the legislative assignment of the Federal Banking Commission it should be made clear that the *safety and soundness* standard must not be assessed in a static manner exemplified by, "are the loss reserves adequate?" Congress must legislate that banks also be examined on a *dynamic* basis: As *going business concerns,* institutions working constructively today for earnings tomorrow. After all, it is the promise of businesses which appeals to securities analysts and investors.

This latter point bears emphasis. A key thrust of the bank regulatory process has been more detailed public disclosure of financial information. The evolution of our financial markets has placed increased reliance upon the market's perception of a company's prospects; i.e. give the market the facts and let it judge a company's prospects by assigning a value to the equity or debt of that company. This, after all,

is what disclosure is designed to facilitate. Economic theory and regulatory policy have been moving in this common direction.

The logical progression of such an approach is to have the regulators also evaluate banks on a "going concern" basis—more in line with the way the marketplace looks at them. This next step should be anticipated explicitly in the legislation.

It can be achieved through the bank examination function taking on an additional orientation: instead of relying upon a totally static (read: liquidation) focus, expand to also include a shared or equally dynamic (read: going concern) orientation. In order to facilitate this added perspective in the bank examination and regulatory process, the national interest objective of fostering a "fully competitive and responsive" banking industry must be in the legislative mandate to the new FBC.

Implications of a Single Criterion Regulator/Insurer

Reflect for a moment on the implications of employing a single criterion in the granting of insurance.

The Federal Banking Commission will regulate to limit the calls on the FDIC insurance so that there is no need to tap the Federal Treasury for excessive losses. That's one of the objectives.

In this context, focus, for example, on the implications of employing a single criterion in establishing an automobile insurance policy.

Imagine, as with the FDIC, that there is only one automobile insurer in the country. Imagine, also, that the standards for underwriting automobile insurance have (as with the Federal bank examiners) only one purpose in mind: to avoid accidents.

Now, imagine what limitations the automobile insurer would require to grant insurance coverage. Remember, the rules are written for this single criterion: avoid accidents!

- Would anybody over 65 years old be insured?
- Would the initial insured driving age really be 15 or 16? Might it be as high as 23? Remember, to avoid accidents is the sole criterion.
- Would one-time "fender benders" be allowed insurance?

Remember, the underwriter has no competition and is only required to avoid accidents.

Now consider the banking industry. Banks, in effect, have to be insured. The bank examiners are the equivalent of the underwriters in the automobile insurance example, and their only mission is to avoid accidents, (read: "bank failures") which may call upon the FDIC insurance fund.

Therefore:

They say: Do not drive over 45 miles per hour.
They say: No turn on red.
They say: Garage your car when there is any snow or ice on the road.
They say: No cars over 6 years old on the highways.
They say: 18 wheelers and passenger cars on separate roads.
They say: One-time speeding offenders are uninsurable.

The automobile business would be very different if the insurance underwriters were guided as they are in my hypothetical example.

And the banking industry is a lot different (read: ***constrained, limited, less competitive, less responsive***) because our banking regulators used a single criterion: avoid accidents.

Surely, our Government and our Federal administrators can assign broader criteria to the banking regulatory function. Surely guidelines which seek accident avoidance as well as competitiveness and profits are not mutually exclusive. Surely this narrowness in the mission of the regulators which inhibits banks from being competitive must be remedied. *Indeed, all of the business schools in the country teach that keeping a company competitive is the best way to avoid accidents.*

Bank Regulation as a Central Bank Responsibility

I will conclude by addressing the most conspicuous objection to the proposed legislation.

The Federal Reserve maintains that they need direct, not just indirect, regulatory authority in order to deal with systemic liquidity risks in the marketplace.

It is true that there are such liquidity risks and it is true that the Federal Reserve is the first agency to go into action by injecting funds into the marketplace, offsetting the contraction inherent in a liquidity crisis.

However, many—perhaps most—of these necessary interventions by the Fed are precipitated by events having little or nothing to do with their bank regulatory responsibilities. This was the case with the surprise Penn Central collapse in 1970. This was the case with the sterling/gold crises in 1967–68. This was the case with

several foreign exchange crises, such as 1978. The 1980's gave us Drexel and there are many more examples.

The Fed has regulatory jurisdiction over only a small fraction of the financial marketplace. Nevertheless, it has demonstrated consistently its capacity to respond effectively to financial crises in areas where it has zero jurisdictional regulatory authority. Indeed, the central bank's intervention frequently commences before the precipitating circumstances are fully appreciated. Such is the nature of the financial marketplace.

This intervention, however, has everything to do with the Federal Reserve's responsibility for monetary policy and the mechanics for its execution. It has little to do with whether Bank A should merge with Bank B; or whether banks should be allowed to have mutual funds, etc.

I will conclude with a quotation from a foremost authority on this issue, the President of the German Central Bank, Dr. Helmut Schlesinger. He made these remarks in March 1991 at a seminar in Budapest, "The Parliament's Responsibility for Economic Development" for which Senator DeConcini and Congressman Steny Hoyer were responsible.

I quote Dr. Schlesinger:

> "Another question is whether an independent central bank should have the full responsibility of banking supervision, which implies having the right to close a bank if necessary, to ask for the dismissal of the responsible bank management, to ask for sanctions, etc.
>
> "My personal impression is that this is not the ideal combination. If a central bank is independent, it cannot or should not act like a Government authority, like a court, or like a bank policeman. The German practice is to leave the authority to a Government agency. The central bank acts only as an agent; it brings in all its expertise, but it has no authority of its own in this field. My attitude is influenced by the observation that an independent central bank can keep its independence even in the event of a bank failure. It should not be forced to try to save a bank by providing central bank money if there is no very strong case for doing so; there should be no conflict between its supervisory and its other central bank functions, its main function, to keep the value of the money stable."

Final Points

- The Federal Banking Commission in practice will reinforce the dual banking system, so I do not see why that is an issue at all.
- Nor do I see at issue the continued independence of the Federal Reserve System in its exclusive management of monetary policy.

PREPARED STATEMENT OF JOHN F. SANDNER

CHAIRMAN OF THE BOARD OF DIRECTORS, CHICAGO MERCANTILE EXCHANGE

Summary

Mr. Chairman and Members of the Banking Committee, this Committee is focused on the consequences of and the cures for the fragmented Federal bank regulatory apparatus. You examined a set of functionally identical institutions, the banks, thrifts and savings and loans, and observed four separate Federal agencies with overlapping responsibilities. The consequences of that structure came as no surprise: inefficiency, inconsistency, duplication, and loopholes. If the larger problem were confined to this one class of institutions, I could support the Administration approach without qualm or reservation.

But, the problem in the Federal financial regulatory structure is not confined to the fragmented regulation of banks. The long-term problem is that the regulators look at banks, money market funds, insurance companies, mutual funds, over-the-counter markets, exchange markets, and other financial service providers as separate institutions susceptible to distinct regulatory schemes. This is the paradigm of institutional regulation that dominates Federal financial regulation. Obviously, in the case of banks, the picture is far more complicated because of historical exigencies that have fragmented that institutional model to the point of immediate regulatory meltdown.

The simpler world that justified institutional regulation has given way to a far more complicated milieu where distinctions among financial institutions have blurred to the point of eradicating the differences and overwhelming the institutional approach to regulation.

You have given me the opportunity to express the views of the Chicago Mercantile Exchange on a subject that we have thought long and hard about: the impact of the

1930's model of Federal financial regulatory structure on the ability of American financial marketplaces and American financial institutions to compete in the financial markets of the 1990's. I'm here to tell you, and through you to tell the American people, that the present Federal financial regulatory structure:

- Is characterized by duplicative regulatory authority over similar market functions, inconsistent regulatory policies addressing similar market practices, and contradictory regulatory goals for similar market developments;
- Is far more costly than is needed to keep the financial markets of the U.S. fair, honest, and accessible, because the multiplicity of Federal financial regulatory agencies necessarily gives rise to repeated reinvention of the bureaucratic wheel; and
- Acts as an impediment, rather than an encouragement, to continued American primacy in the financial market arena—and as an impediment to economic growth generally in the U.S.—because duplicative, inconsistent, contradictory, costly regulation is a price that participants in the linked financial markets of the 1990's need not and will not bear.

The present Federal financial regulatory structure is not broken in the sense of a machine that has ground to a halt, but it *is* malfunctioning badly and visibly in the inhibition of financial market innovation and the imposition of artificial legal barriers on financial market competition. It *is* broken in the sense of the ever-increasing, ever-more-perceptible erosion of American financial market share and the loss of financial market jobs and dollars for the U.S. economy.

We, at the Chicago Mercantile Exchange, have publicly proposed what we believe could be a model for a revamped Federal financial regulatory structure—a constructive "fix" for a system clearly "broken" in many fundamental regards. Our model would consolidate Federal regulation of *all* financial market participants to achieve coordination of regulatory policy across institutional lines, and would organize the newly consolidated Federal financial regulatory service so that financial products and services delivering similar benefits and risks can be subjected to substantially equivalent regulation and so that economic competition rather than jurisdictional barriers or differences in supervision can determine which products, services, and market instrumentalities succeed in the marketplace.

While we have invested great effort in refining and promoting our model, we realize that the obstacles to reform are high and broad. S. 1633, introduced by Senators Riegle and D'Amato, demonstrates a finer appreciation for political reality. The Administration and the Federal Reserve have also weighed in with competing reform proposals. Our principal reservation respecting all of these efforts is that successful reform in the banking sector will lessen or eliminate the pressure for the kind of reform that will lead to a replacement of institutional regulation by genuine functional regulation. Ironically, what is obviously good for the banking industry may be bad news for the ultimate goal of reforming the overall structure of financial regulation in the United States.

On behalf of the Chicago Mercantile Exchange, I want to thank you for the opportunity to present our analysis and our model for your consideration.

Testimony

I. The President's Call for Change

I was honored to be invited to speak at President Clinton's Little Rock economic conference in December 1992 on the very issues that this Subcommittee is now addressing. In his "Vision of Change in America," President Clinton asserted:

> The Federal Government is more complex than it needs to be. Often, many different agencies deal with the same issue and individuals, businesses, communities, and States find it impossible to have their problems addressed. Departments and agencies are already consolidating and simplifying their operations, and the Administration will seek to rationalize and streamline functions Government-wide.

With that in mind, we have put forth a vision of our own. I suggested that every rule, policy, and regulation should be promulgated only after answering the question: "Does this help or hurt business?" I called for a new partnership between Government and business that will benefit the American people with new jobs and economic growth. Since that time, in response to the Administration's request and in response to Vice President Gore's National Performance Review, we have refined our ideas and drafted a specific plan for regulatory reform. Premised on the fact that the Federal financial regulatory structure has not adapted to the changes in U.S. financial services and how they're delivered, the Merc has developed its own "Model for Federal Financial Regulation."

II. A Space-Age Industry Cannot Operate Under Horse-and-Buggy Regulation

The hard truth is: We cannot expect to remain globally competitive for the balance of this century and on into the 21st, unless we move now to rethink and reshape our country's scheme for regulating financial services. In a nutshell, America cannot continue to regulate a space-age industry with horse-and-buggy rules.

Back in 1934, when the Congress enacted the legislation establishing the Securities and Exchange Commission, the only futures markets in existence were actually domestic marketplaces for agricultural commodities. That was largely true even 19 years ago when the Commodity Futures Trading Commission was established.

Today, nearly everything about our industry has changed. The Chicago Mercantile Exchange, for example, is no longer solely an agricultural-commodity marketplace. Rather, it is among the world's busiest financial risk and asset management centers. In 1982, our "commodity" marketplace posted a daily average of 133,000 contracts traded. Today, an average of nearly 900,000 futures and options are traded daily at the Merc. The annual notional dollar value of all this is over $150 trillion.

Nowadays, 60 percent of the Merc's annual volume derives from interest-rate futures and options, 23 percent from currencies, 12 percent from stock indices and less than 5 percent from the traditional commodities, the agricultural products. In addition, futures options, which didn't even exist until 1983, now constitute nearly a fifth of our volume.

Due to modern technology, the microchip, fiber optics, and satellite communications, none of this has happened in isolation. In 1982, volume for the entire industry was 112.4 million contracts traded. Outside the United States, there was just one financial futures exchange, the London International Financial Futures Exchange. Today, LIFFE, as it is called, is just one of more than 30 such exchanges, located in almost every major city in the world, trading financial futures and options on the open out-cry auction trading system we created. Two years ago LIFFE, for the first time ever, posted volume greater than either the Chicago Merc or the Board of Trade on the same single day. This year LIFFE is regularly out-trading both.

Those 30 exchanges are not our only competitors. We compete with, and to some extent are nourished by, the interbank currency markets and the off-exchange and over-the-counter markets—which have grown and continue to grow dramatically. All of which is fine, as long as we're allowed to compete. It's just that our financial-services rulebook, first conceived six decades ago, is totally inadequate on the threshold of the 21st Century. We're being asked to play the Dallas Cowboys in our leather helmets with Amos Alonzo Stagg's playbook. Under those circumstances, you wouldn't be inclined to bet the ranch on us.

The laws now on the books are vestiges of a very different era. When business was retail-oriented. When there was little or no international competition. When futures and securities were clearly delineated. Now it's all blurred: products, services, market participants, and the marketplaces themselves. Meantime, regulation has been piled upon regulation, nearly always in reaction to some "problem that had to be fixed."

III. There is Broad Agreement

Excepting those very few firms that are direct beneficiaries of regulatory inefficiencies, all those involved in the financial services industry—banks, securities firms, commodity firms, money managers, insurance companies—universally agree that the current regulatory structure for financial services imposes costly duplications, inefficient operations, and barriers to competition. The current regulatory structure has the following adverse features:

- ***An outmoded regulatory system is choking the competitive spirit of the U.S. financial services industry;***
- ***The contours of the regulatory landscape are as damaging to the industry as is the philosophy of the regulators;***
- ***Institutions offering functionally identical products are subject to separate and inconsistent regulatory regimes; and***
- ***In many cases, the performance of a single function is subject to inconsistent, overlapping regulation.***

An outmoded regulatory system is choking the competitive spirit of the U.S. financial services industry: The financial services industry in the United States has lost its competitive edge to off-shore competition. Our people have not lost their aggressiveness or their technological superiority, but our regulatory system is in the process of forcing the best and the brightest to operate overseas and of allowing foreign competition to usurp the inventions of U.S. markets and our financial service industry.

Futures and options markets foster their business of providing risk management services by offering low costs and liquid markets. U.S. futures markets are world leaders because our costs have been lower and liquidity better than those of our foreign rivals. Our foreign competitors are rapidly cutting into our lead by copying our best features and avoiding the regulatory and structural defects that weaken our markets. Regulatory excesses jeopardize our fragile competitive lead and threaten the export of this cost-sensitive business to jurisdictions that understand the consequences of inappropriate regulation of such highly-mobile businesses.

The U.S. futures markets are actors in a global marketplace that includes regulated exchanges and unregulated over-the-counter markets. The push of a button instantly moves business from country to country, accessing the most efficient, least costly markets. The specter of markets moving overseas is not fantasy. On four recent occasions, when the operations of U.S. markets were temporarily impaired, the business was immediately transacted in Europe. No one waited on the sidelines for the given U.S. market to reopen.

The contours of the regulatory landscape are as destructive of the industry as is the philosophy of the regulators: The present Federal regulatory system regulates institutions without regard to the economic service being provided. This system is an artifact of times when we had domestic markets performing for retail users in a stately fashion. Those were times when banks were banks and brokers were brokers and their functions were clearly delineated. When this delimitation is combined with the various grants of exclusive or limited jurisdiction to the regulators, a strange landscape of contradictory regulation is the invariable product. That landscape is speckled with the land mines of costly, inefficient, duplicative, and inconsistent regulation.

Institutions offering functionally identical products are subject to separate and noncoordinated regulatory regimes: The operation of open and competitive domestic and international markets for financial products and services has in recent years driven traditionally distinct financial market participants and financial marketplaces, both in the United States and worldwide, to imitate and to duplicate each other's functions. Money market funds with check writing privileges imitate banks. Bank collective trusts imitate mutual funds. Corporations couple futures contracts and options to their debt issues to make them more attractive to institutional investors. Over-the-counter markets imitate all of the features of regulated markets without the impediments of regulation, fees, and taxes.

The Federal financial regulatory structure has failed to adapt to these market changes as U.S. financial services have changed dramatically and international competition has increased exponentially.

In failing to keep pace with the changing realities of the financial markets, the existing regulatory structure has undermined its own effectiveness. In many contexts it has become counterproductive to desirable economic activity. Rather than providing conditions for market changes and innovations to occur with maximum systemic safety, it has tended to stifle competition and innovation.

In many cases, the performance of a single function is subject to inconsistent, overlapping regulation: The Federal financial regulatory structure, by relying on institutional rather than functional regulation, has magnified regulatory costs by replicating regulatory activities in multiple agencies that all too frequently pursue conflicting policy and bureaucratic goals at the expense of financial market participants.

The consequence of costly, unnecessary regulation is loss of market share: The regulatory philosophy and the structure of financial services regulation have combined to weaken our industry's position in world finance. We must understand the ease with which business may be transported beyond our borders. We have seen the domestic U.S. Treasury Bond trading market move to England in a matter of seconds when a domestic exchange could not operate. We have seen a transaction tax destroy a nascent market in Sweden and the inability to revive that market after the fact. We have seen oppressive Japanese regulations push enormous volumes of Japan's natural business to Singapore. The record is clear: When a market becomes more expensive by reason of transaction taxes, or by reason of regulations judged not to be cost-effective by market users, the market evaporates and is reincarnated in a country with a better understanding of the economics of trading and the needs of market users.

A hostile regulatory philosophy, keyed to the moment-by-moment protection of widows and orphans, is being applied to a highly self-regulated, compliance-oriented financial market dominated by financial institutions: As regards regulatory philosophy, what started out as oversight of regulation by self-regulatory organizations has now become micromanagement of all aspects of the financial services industries, sometimes by Congress and always by the regulatory agen-

cies involved. We must go back to relying on effective self-regulation backed by strong oversight of the self-regulatory organizations' activities. The fundamental Federal regulatory philosophy should of course be skeptical and demanding, in view of the financial industry's stewardship of other people's money, but should not be allowed to become so inherently adversarial as to be counterproductive to the public's ultimate need for financial market leadership in the U.S.

The financial regulators are reluctant to allow market forces to rule market behavior: It is clear to all experienced market professionals that the market is the best and most effective judge of whether a product serves a legitimate purpose and need. Products that do not serve such needs fail—at great cost to the sponsoring entity.

I want to provide some specific examples. The ones that come most readily to mind focus on the CFTC, with which I am most familiar, though I am assured by my friends in the securities and banking industries that our experience is shared throughout the financial services industry. The original philosophy of regulation in our industry was to require effective self-regulation backed by strong Federal oversight of the self-regulatory organization's activities. That philosophy has eroded beyond recognition. Regulation is now founded on micromanagement starting at the congressional level and reinforced at the agency.

But, the single greatest impediment to the continuing viability of organized futures markets is the requirement that rules and contracts be approved in advance of implementation and trading. Astute regulation in comparable countries allows exchanges to adopt and implement rules subject to disapproval by the regulator in the event that the rules are contrary to law or regulation. New contracts may be traded without first passing regulatory scrutiny.

In contrast to the U.S., the U.K. regulator requires notification but not advance approval of futures contracts. It views listing a new futures product to be the exchange's "commercial decision" and as little as one day's notice is needed before launching a new product. The U.K.'s LIFFE is now the world's third-largest futures exchange, and growing, even though it started little more than 10 years ago.

At the request of market participants and clearing members the CME created a program to allow equity securities that make up the S&P 500 to be deposited as performance bond collateral at the Clearing House. On January 7, 1991, the CME submitted proposed amendments to rules 821 and 825 to permit deposits of stock as performance bond collateral to the CFTC. These amendments were finally approved in April 1992. In contrast, the Options Clearing Corporation, subject to Securities and Exchange Commission ("SEC") regulation, has been accepting stock receipts as performance bond collateral since 1982. No one has ever demonstrated that public policy interests would not be served if the CFTC's power were limited to repealing or amending contract market rules.

Money managers now typically need to use derivatives for hedging and/or yield enhancement. As a result, they must register both as Investment Advisors and Commodity Trading Advisors or Commodity Pool Operators. They must therefore satisfy both the SEC's and CFTC's rules and requirements.

On a similar note, the vast majority of brokers are SEC registrants but lack CFTC registration. The CFTC registrants often lack the corresponding SEC license. This dichotomy means that most brokers are limited to recommending a single market when dealing in currencies, interest rates, and equity indices. Customers suffer from the constraint to the extent that they are offered an incomplete view of the market and often fail to get the best price or the best product available.

Financial firms frequently find themselves subject to overlapping investigations and audits from the numerous agencies that have separate responsibility for their divisions and subsidiaries. The uncoordinated investigations are not likely to produce a full and accurate picture of the firm's overall operations and condition. The problem is even more pronounced when a bank is involved.

Capital requirements for financial firms vary from regulator to regulator and produce a kind of "regulatory shopping" that disadvantages firms that do not participate in banking, securities, and futures. Consistent, risk-based capital requirements would eliminate these discrepancies and ultimately enhance the safety of the system as a whole.

Changes in substantive law and regulatory attitudes will be important, but structural change is required to achieve greater flexibility, responsiveness, cost-effectiveness and efficiency in Federal financial regulation. Some seem to feel that a merger of the SEC and CFTC amounts to the quick and easy route to reform. In fact, a hostile takeover has been on the SEC's agenda for some time. That is a cosmetic approach. It's form over function that would really stifle the creativity of the U.S. futures industry. We would oppose such a solution vigorously.

Summary: The bottom line amounts to what I said to the President in Little Rock, at his economic conference:

> Government cannot help business at the expense of individual welfare. But too many rules follow the motto "you cannot be too careful." The truth is you *can* be too careful. Government can and should help business do its job. And the economy will be fundamentally stronger as a result. . . .
>
> If the slate could be wiped clean, what tax and regulatory structure would we want for the long-term growth and prosperity of our citizens? We would build it around incentives to help business success. . . . Business can no longer tolerate stifling regulations and the micromanagement by Government that threatens its productivity and its very existence.

To quote from the 1986 House Subcommittee Chairman's Report entitled "Restructuring Financial Markets: The Major Policy Issues":

> There is a uniting theme in the extensive body of law and regulation governing U.S. financial institutions: *recognition of the financial system's economic role.* Unless the system as a whole facilitates the transformation of financial capital into economic activity and growth, other objectives and strategies—including those that protect customers—will be ineffective.

IV. Where Do We Go?

We at the Chicago Mercantile Exchange propose a sweeping overhaul of the regulatory structure based on functional regulation by product, not by exchange or industry. Such an overhaul has the potential to reduce Government spending, help the U.S. financial services industry better compete in a global environment and better protect U.S. consumers whose savings and investments are crucial to the success of an economic recovery.

These are extraordinary times in which conventional wisdom matters little. The House Banking Committee's Subcommittee Chairmen, in a letter to Speaker Foley, have asserted correctly that "jurisdictional bickering is one of the most unfortunate reasons why we have institutional gridlock, resulting in the failure to pass many important and needed pieces of legislation."

While gridlock has persisted, U.S. dominance as the home of organized derivative financial markets has eroded. In just the past 4 years, our share of world markets has shrank from over three-quarters to just over half. Admittedly, the pie has expanded, meaning that our volume continues to grow somewhat. Still, we cannot ignore the offshore growth, particularly when England, France, Germany, Japan, and Singapore have made such considerable strides using our model—with a crucial difference. Save for Japan, they all benefit from enlightened, cooperative regulation, which is why they have made such significant strides.

In light of all this, ours is a realistic model for restructuring financial-services regulation. It paves the way for substantial savings in administrative costs, some $300 million by our conservative calculations. Equally important, it would nourish substantial growth and productivity in the U.S. financial-services industry, creating thousands of additional jobs.

V. The Case for Restructuring Financial Regulation

A. BACKGROUND

The current regulatory structure imposes costly duplications, inefficient operations, and barriers to competition in the markets. To understand how we got to this point, recall that the SEC was authorized in the wake of the Great Depression, massive bank failures, and the stock market crash of 1929. The basic regulatory structure for securities markets in the U.S. has not changed in nearly 70 years. The CFTC, on the other hand, was created in 1974, when futures markets were largely confined to physical, storable, deliverable commodities, and options barely existed. Nineteen years later, the volume of trade in financial futures and options products on currencies, interest rates, and stock indexes dwarfs that of physical commodities.

On October 8, 1992, almost *4 years* after reauthorization legislation for the CFTC was introduced in Congress, a final compromise bill was passed—reauthorizing the agency for *2 years*. During the 4 years it took to pass the bill, the world's financial landscape changed dramatically and many new financial products and services were introduced. Some of these products are regulated by the SEC, some by the CFTC, some not at all. While these products were coming to market, the SEC and the CFTC were engaged in a "turf fight" over the regulation of stock index futures that led to bitter feelings at each agency. At the same time, various interests in the financial products arena, regulators and Congressmen spent inordinate amounts of time determining the future course of regulation in the over-the-counter derivative markets. Fifty members of the Congress, representing four separate committees of

the House and Senate, were appointed to a conference committee, which found it impossible to meet even once between November 1991 and July 1992. Now that the CFTC has been reauthorized for only 2 years, the entire process could repeat itself, and at what cost to the taxpayer who does not see the need for this?

The markets have changed dramatically in the past two decades. The financial service industry was the domestic retail oriented small and technologically slow and inefficient. Those markets are today global, institutional, huge, and technologically at the cutting edge. What was a stock market dominated by individual stock traders in 1970 is now a market dominated by institutional investment managers. The savings and pensions of the average American are now, to an increasingly greater extent, "passively invested" through mutual funds, pension funds, IRA's and 401(k) plans. "Indexation," the process of trading market segments or the market as a whole rather than individual stocks, has gained an enormous and growing following because of the proven risk-reducing and yield-enhancing value of portfolio diversification. Today's professional money managers allocate assets among a variety of stock, bond, commodity, and money markets in their quest to maximize returns to their clients. Stock index futures and options, first introduced in 1982, are now recognized as essential ingredients in trading stock portfolios.

In today's world, the distinct functions performed by distinct institutions no longer apply. Indeed, different institutions now perform similar functions and offer similar products and services to common users across markets. The examples are easy to list—banks sell stocks, mutual funds invest in money markets, banks and insurance companies offer mutual funds, securities professionals offer risk management strategies and futures professionals offer hybrids, cash and asset allocation transactions, etc.

The result of the institutional regulatory concepts we currently labor under are:

- Unwieldy regulatory Agencies
- Unconscionable mountains of regulation
- Agencies consumed with protecting "turf"
- Agencies which compensate for lack of knowledge or willingness to innovate by oppressive micromanagement
- Agencies which duplicate each other's audits, enforcement, and regulation
- Agencies which create inconsistent regulations for the same product

The motives and reasons for today's financial services regulatory scheme are hopelessly antiquated.

B. RATIONALE

A unique window of opportunity now exists to overhaul our regulatory structure so that our homegrown U.S. financial markets can enter the 21st Century able to compete effectively in a world where financial products know no borders. Unless we act now, we are assured more of the same.

The process must now begin to bring us into the 21st Century with a rational, functional system of regulation for a major portion of the financial services industry. Congress is full of new faces and new chairs will be confirmed to both the SEC and CFTC. As recently as 10 years ago, overseas markets represented no threat. Today their rapid expansion may serve to catalyze the leaders in the domestic financial services industry to put aside narrow self-interests in favor of the broader concerns of the industry.

Perhaps the most compelling reason for this effort is to assure the continued competitiveness of U.S. financial services in an increasingly fierce global arena. Ten years ago the U.S. market share in financial futures and options approached 100 percent; today it is less than 50 percent as risk management exchanges and products have proliferated in financial capitals worldwide. Ten years ago there were no significant financial futures exchanges outside of Chicago; today there are more than 30. Our foreign competitors, for the most part, do business under generally user-friendly, single-regulator frameworks.

C. SOME KEY TENETS

First, it is essential that the new regulator be committed to cost-effective regulation that will save tax dollars, relieve the industry of the burdens of duplicate regulation and uncertainty, and make it cheaper for the end users to participate in our markets.

Second, the preexisting regulatory schemes and personnel should not simply be cobbled together under a new name.

Third, an active and continuing program to eliminate past prejudices against particular products, markets, and sales practices must be in place and assured. In particular, the open out-cry auction market, which has served the futures industry so

well, must be afforded the same respect as the securities industry's market maker and specialist systems.

Fourth, the system of self-regulation must be preserved and broadened to permit self-regulatory organizations to act subject to agency review and disapproval without continuing to permit regulators to delay innovation and experimentation. Finally, any program must recognize the right of clearing organizations to set performance bonds (margins) at prudential levels.

VI. The CME's Regulatory Model

The Chicago Mercantile Exchange believes that now is the time to propose a new regulatory structure.

Federal financial regulation:

- Should be consolidated in a single *cabinet-level* department within the Executive Branch of the Government so that regulatory policies can be coordinated across financial products, services, and markets and so that the regulators and the Administration can be held accountable for the success or failure of their policies.
- Should be organized along modified functional lines so that financial products, services, and markets delivering similar benefits and risks can be subjected to substantially equivalent regulation and so that economic competition, rather than jurisdictional barriers or differences in supervision, can determine which products, services, and markets succeed in the marketplace.
- Should be structured to encourage innovation in domestic financial activities and adaptation in international markets so that financial products, services, and markets can evolve in response to presently foreseeable and still-unperceived developments and challenges.

The model we propose is designed to accomplish these goals and to balance the need for efficiency in Government regulation with the equal need for safeguards against Government overreaching and market intrusion.

In brief, the major features of the model that we propose are as follows:

- Existing agencies consolidated in a single cabinet-level department
- New Federal Financial Regulatory Service governed by nine-member Board
- FFRS divided into eight operating divisions
  - —Division of Prudential and Systemic Risk
  - —Division of Disclosure and Reporting
  - —Division of Fiduciaries and Pooled Vehicles
  - —Division of Investment Securities Markets
  - —Division of Risk-Shifting Markets
  - —Division of Banking and Insurance
  - —Division of Consumer Protection
  - —Division of Customer Insurance
- Cross-divisional legal, accounting, economic, examination, and enforcement staffs reporting directly to the FFRS Board
- Separate administrative court to hear enforcement cases and appeals

The full text of the model we propose, accompanied by a schematic portrayal, is appended to this testimony.

Conclusion

All human institutions need to be restructured from time to time. The framework for the current system dates to the 1930's. In the last 20 years, U.S. financial services have changed, grown, and been challenged dramatically in a global, competitive environment. Regulation has not kept pace and, indeed, has been an impediment to efficiency, growth, and competitiveness. The time to rationalize and restructure the Federal financial regulatory agencies is now so that we may position our financial services industry for the 21st Century. The Chicago Mercantile Exchange has presented, and is proposing to you, a model for doing so—prudently, flexibly, efficiently, and "with recognition of the financial system's economic role."

While we have invested great effort in refining and promoting our model, we realize that the obstacles to reform are high and broad. The process that will eventually lead to broad reform must begin at some level. The fractured structure of banking regulation seems the best candidate for this initial step.

PREPARED STATEMENT OF LAWRENCE CONNELL

CO-CHAIR, SHADOW FINANCIAL REGULATORY COMMITTEE

Mr. Chairman, Members of the Committee, thank you for inviting me to offer comments for the Shadow Financial Regulatory Committee on proposals for consolidation of the bank regulatory apparatus.

The Shadow Committee has issued two statements on the subject. Number 100, which was issued December 13, 1993, commented on the U.S. Treasury Department proposal. Number 103 was issued on February 14, 1994, and set forth certain objectives and principles that the Shadow Committee believes are important when addressing regulatory structure. Copies of both proposals are attached for your reference.

I will begin with the objectives and principles. They are the following:

A. Objectives

1. OPERATIONAL EFFICIENCY OF FINANCIAL INSTITUTIONS AND REGULATORY BODIES

Any proposal should improve not just the operational efficiency of the governmental agency itself, but also the institutions they regulate. The Treasury proposal would help achieve both objectives by reason of efficiencies gained in the consolidation of many duplicative functions of several agencies and by reducing costs to financial institutions with respect to such matters as duplicate examinations and redundant, inconsistent reporting, and application requirements.

2. EFFICIENCY OF FINANCIAL MARKETS IN THE ALLOCATION OF RESOURCES

Efficiency of markets brings products and services to the consumer at the lowest costs. The Treasury proposal, by reducing the regulatory burden on market participants, would improve allocation of resources in banking markets.

3. INNOVATION IN FINANCIAL MARKETS

By removing regulatory authority from the Federal Reserve and the Federal Deposit Insurance Corporation and vesting that power in the Federal Banking Commission as chartering agency, the Treasury proposal will facilitate innovation in financial markets served, or potentially served, by depository institutions. It is the chartering process that provides the dynamism so necessary to meet the ever-changing needs of the marketplace. The Federal Reserve has consistently subordinated this role to its political and monetary policy objectives. Although the Federal Reserve is not a chartering agency, its Bank Holding Company Act authorities, effectively make it the generator of powers to bank holding companies. The slow response by the Federal Reserve in granting new activities to bank holding companies, and in Administration of Regulation Q in the face of rapidly changing market conditions greatly contributed to the loss of market share by banks and bank holding companies. To continue the Federal Reserve in a regulatory role will only stifle institutions in the years ahead.

4. MINIMUM DEPOSIT INSURANCE LOSS EXPOSURE

The Treasury proposal is deficient in that it does not include a representative of the Federal Deposit Insurance Corporation on the Federal Banking Commission. This is important because it is the FDIC's funds that are at stake and it would be expected to be the most concerned about potential losses.

5. EFFECTIVE MONETARY POLICY

The Shadow Committee believes monetary policy would be more effective if the Federal Reserve focused its attention on that role without the additional time consuming and sometimes conflicting financial institution regulatory responsibilities. As will be stated later when issues such as bank solvency and exposure to the deposit insurance fund conflict with broader economic issues such as credit availability, better policy will result if the conflict is externalized rather than resolved internally, in secret.

It is most important that regulatory officials be accountable for their decisions. Accordingly, the Committee believes accountability in regulatory policy would be greatly aided by the following:

B. Principles

1. CLARITY IN GOALS AND POLICIES

With four different agencies involved with different roles, clarity of regulatory goals is not possible. Consolidation would clarify regulatory goals and policies.

2. Transparency of Policy Decision and Underlying Decision Criteria

A properly structured banking commission would provide greater transparency of policy decisions. Only by providing full and honest information to the public will accountability be achieved.

3. Insulation of Policies from Short-Term Political Decisions

The Treasury proposal falls short in this respect by including the Secretary of the Treasury on the Commission. The Shadow Committee recommends that the Secretary of Treasury be removed and a representative of the Federal Deposit Insurance Corporation be substituted.

4. Assignment of Potentially Conflicting Goals to Separate Agencies

Responsibility for monetary policy and prudential regulation should not be lodged in the same supervisory agency. Responsibility for approving new institutions and products should be separated from the insurer. The Treasury proposal would further this principle. The Federal Reserve proposal would do just the opposite.

On balance the Shadow Committee believes the Treasury proposal is a good beginning in the rationalization of the financial institution regulatory structure. It could be improved by the suggestions set forth in policy statement 100. In the past Members of the Committee had concerns about a perceived monolithic regulatory structure and its effect on the dual banking system. However, both concerns have been muted by the development of alternative financial products and markets over the past few years.

The Treasury proposal facilitates the role of State regulators in the examination and supervision process by specifically requiring acceptance of State examination reports.

The Federal Reserve proposal, by adding regulatory supervision of State-chartered banks and savings and loans associations to its current authority over State member banks and bank holding companies, is a thinly disguised effort to make it the Federal Banking Commission. Its reach would effectively only omit the few remaining national banks and savings and loan associations that were not part of a bank holding company. If the Federal Reserve proposal were successful, the result would be the worst of all worlds. Many of the objectives and policies set forth by the Shadow Committee would not be achieved. Accountability, transparency, conflict resolution, and innovation would be lessened. Most importantly, history suggests that the Federal Reserve is institutionally incapable of facilitating innovation necessary to a dynamic banking charter required to meet the changes of the marketplace. This results in inefficient markets and poor allocation of resources.

The Federal Reserve has responded to any attempt to curtail its power by raising the specter that such legislation would render it unable to deal with systemic risk in the financial system.

When the Federal Reserve was founded in 1913, to deal with liquidity crises, membership was voluntary except for national banks. Over the years the Federal Reserve expanded its regulatory reach to international and securities activities of banks, consumer protection issues, and holding company activities, none of which were vital to its systemic risk or liquidity crisis roles, but merely represented 80 years of astute bureaucratic and political maneuvering.

The Treasury Department's regulatory restructuring leaves undisturbed the Federal Reserve's real systemic risk and liquidity crisis functions, namely the discount window, open market operations, and payments system authorities. The secrecy surrounding the Federal Reserve operations and the general aura of the workings of the money markets has generally frustrated any examination of what the Federal Reserve really needs to conduct its traditional statutory role. By merely raising the specter of systemic risk and the fear that the world will end if the Federal Reserve were not there, opposition from the press, Congress, and even the banking industry, evaporates. Since the name of the game in Washington, DC is power, the Federal Reserve uses these opportunities to expand its power, no matter whether related to monetary policy, liquidity crises, or the payments system.

A close examination of the Treasury Department's proposal clearly shows that the Federal Reserve retains its authority to provide funds to both the economy and to financial institutions in times of liquidity crises, and that is quite obvious. Recall, it was the Federal Reserve's failure to provide funds to the economy in the early 1930's when it had that power that contributed to the worst economic depression in U.S. history. What is not generally understood is the pervasive authority that the Federal Reserve retains under its payment system functions. Under this authority, which the Federal Reserve has over all types of financial institutions, both bank and thrift, each institution may be limited in its daily exposure as its checks and transfers clear through the payments system. The daily exposure, which is called a day-

light overdraft, must be approved by the Federal Reserve. Thus, the Federal Reserve has complete control not over only providing funds in a financial crisis, but also in restricting bank exposure to other banks. These powers are all the Federal Reserve needs to carry out its responsibilities to prevent systemic risk because it can monitor money flows and can secure any financial information it requires to determine the health of clearing institutions.

The Treasury goes even further in accommodating the Federal Reserve. As Under Secretary, Frank Newman's, description of the proposal states, "The Federal Reserve would retain authority to set standards for, and *examine,* activities related to the payment system and discount window." In addition, the Federal Reserve could participate in the Federal Banking Commission's examination of a limited number of banking organizations most significant to the payments system. Thus, the Federal Reserve would not be out of the loop in any real way with respect to information regarding the financial condition of banking organizations.

It also has been argued that the Federal Reserve needs broader regulatory authority in order to be able to "arm-twist" banks to take risks they ordinarily might not, such as lending to banks, foreign governments, and insolvent companies, e.g. to LDC's in the early 1980's. This would be bad Government and would only result in a future disaster as the LDC experience showed. Credit risks should be borne directly by the Federal Reserve.

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Statement of the Shadow Financial Regulatory Committee

on

The Proposed Federal Banking Commission

December 13, 1993

The Clinton Administration recently proposed combining the supervisory and regulatory functions of the four federal banking agencies (Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation and Office of Thrift Supervision) into a single Federal Banking Commission. Under the proposal, the Federal Reserve Board would retain responsibility for monetary policy, the payments system, and liquidity. The FDIC's role would generally be limited to insuring deposits and resolving failed and failing banks.

The objectives of the agency restructuring, according to its drafters, are consistency of regulation and implementation, improvement in efficiency, improved accountability and greater independence of regulatory and supervisory actions from political influence.

The Committee believes the proposed restructuring is a step forward in reducing the increased complexity of the depository institution regulatory structure. The current structure is fraught with duplication, imposes unnecessary costs on the industry, has resulted in inconsistent policy, and has permitted the agencies to avoid accountability by diffusing responsibility. In addition, the political independence of the supervision of federally chartered depository institutions has eroded over the past twenty-five years.

Rationalization of the regulatory process has always been frustrated by agency turf battles unrelated

to substance. The most vigorous opponents of reform have been the agencies themselves. In particular, the Federal Reserve has claimed that participation in bank supervision and regulation is necessary for it to deal effectively with systemic risk and liquidity crises. The Committee disagrees.

Under the Administration's proposal, the Federal Reserve will have sufficient information, independence, and control to implement monetary policy, and will have the capacity to deal effectively with liquidity crises and systemic risk. The Federal Reserve will retain full access to other agencies' examination reports and will retain its powers with respect to open market operations, reserve requirements, the discount window and payment functions, such as daily overdraft exposure.

A potential objection to the Administration's consolidation proposal is that it may harm consumers of financial services in the long run by limiting the regulatory choice that banks have historically had. In the past this choice has often enhanced market competition and facilitated innovation. While this Committee has been receptive to this view in the past, market evolution has lessened the need for regulatory competition in the banking industry. Today, intense competition between banks and nonbank financial institutions provides ample opportunity for consumers of financial services to reap the full benefits of competition and financial innovation.

While the Committee supports the Administration's proposal as a useful first step, it recommends the following:

(1) to enhance protection of the deposit insurance fund, the Chairman of the FDIC should be a member of the Commission;

(2) to enhance the independence of the Commission, the Secretary of the Treasury should not be a member, nor should the Commission be dominated by ex officio members;

(3) that any such restructuring should be combined with an agency internal organizational structure that enhances regulatory accountability;

(4) that supervisory restructuring is not a substitute for the substantive regulatory reform that changes in technology, markets, and social needs demand; and

(5) that credit unions should be included.

GROWLERY

Conflicting Objectives of Financial Regulation

Financial regulation has multiple objectives. These include safety and soundness, competitiveness, fair treatment, disclosure, resource allocations, avoidance of abuses, and monetary management. Because these objectives often conflict, there needs to be a means for explicit and open resolution of conflicting objectives with elements of regulatory activity. Currently, the resolution process is obscured from view The public rarely knows what the full considerations are that underlie regulatory actions or failures to act. Even more rarely are the tradeoffs inherent in a decision (or a nondecision) made known.

The major S&L and banking losses of the past decade and a half led to the enactment in 1991 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA). It is designed to increase bank regulatory accountability in at least three ways: (1) prompt corrective action in the event of declining capital positions; (2) least-cost, prompt resolution of those depository institutions failing to maintain minimum capital; and (3) reforms in valuation procedures offering more transparency in assessing the condition of institutions and the performance of regulatory agencies. Whatever are the prospects that future regulatory performance will meet the FDICIA objectives, that Act did not address resolution among conflicting objectives of financial regulation.

Failure to address conflict resolution is also a common feature of proposals for consolidating functions of bank regulatory agencies as well as the agencies themselves. This failure surfaces with some regularity. The need for "streamlining," such as functional specialization and reduction of overlapping jurisdictions, is often cited as a justification for action. Another is reduced regulatory autonomy—for example, a recent legislative proposal by Henry B. Gonzalez, Chairman of the Committee on Banking, Finance and Urban Affairs. If the past record on efforts for agency reorganization is any guide, however, inertia and vested interests will continue to be difficult obstacles for proponents of change to overcome. Indeed, even changes in regulation per se often require severe financial dislocations before action is taken.

Delineating objectives

The following classifications represent a menu of regulatory objectives and apply to all institutions offering financial services to the public. These objectives also cover the full range of financial functions, which include credit, investment and deposit instruments, funds transfer, securities transacting, investment underwriting and distribution, mutual-fund management and distribution, pensions, and insurance.

• *Safety and soundness*—covering capital rules and oversight, early intervention and resolution, deposit insurance, on-site examinations, securities investor protection, single-borrower limits, brokered deposit restrictions, clearance and settlement of market transactions, and pension benefit guaranty;

• *Competitiveness*—covering new charters, permissible functions, permissible geographic locations, and mergers and acquisitions;

Suggestions on an earlier draft from Robert Eisenbeis and Edward Kane are acknowledged with gratitude

• *Fairness of customer treatment*—covering information about credit and deposit terms, terms of other transacting (including securities purchases and sales), dispute resolution, and nondiscriminatory availability of services;

• *Disclosure and reporting*—covering accounting policies, balance-sheet valuation techniques, content and format of regular reports, special reports (e.g., under ERISA), and event disclosure;

• *Avoidance of conflicts and abuses*—covering treatment of fiduciary standards and avoidance of conflicts of interest, improper self-dealing, tie-in practices, and insider abuses;

• *Allocative preferences*—covering special programs for services (for example, credit and transactions services) to be furnished to designated sectors;

• *Monetary management*—covering elements of control mechanisms claimed to be required in the conduct of monetary policy.

Using the current U.S. regulatory oversight as a starting point, the only objective of the seven where accountability for action is relatively unambiguous is monetary management. This is, of course, the province of the Federal Reserve.

Proponents of functional reform want all oversight of a given kind of financial service (for example, securities underwriting) concentrated in a single agency. This approach should be resisted on two grounds. First, as usually employed, the term "function" is static and often fails to cover close substitutes. Indeed, failure is predictable, if there are returns to regulatory avoidance. Second, functional specialization presupposes scale economies of oversight. Skepticism is warranted on this score. If past experience is any guide, reorganization of government agencies typically is accompanied by expanded employment and higher costs, not the opposite.

Regulatory complexity

Regulatory objectives are not only more numerous than is commonly recognized, but their complexities are often masked in superficial and innocuous language as well. Consider the Federal Reserve's own description: "In its role as the central bank and as lender of last resort the Federal Reserve has a basic responsibility for the financial stability of the economy. Intrinsic to this responsibility is a concern for the strength and stability of the banking system and for the consistency of the banking structure with needs of monetary policy."

The terms "concern for," "strength," "stability," and "consistency" imply that the Federal Reserve should or will undertake actions that will improve conditions. This suggests the possibility that nonbanks (i.e., those outside the direct purview of Federal Reserve supervision) could be at a disadvantage. It also suggests that actions in one direction could impair results sought in another. Although the means by which even these three are reconciled is not disclosed by the Federal Reserve, it is often presumed that, in matters of monetary policy, that function had priority.

But the process is more complex. The Federal Reserve's list of objectives omits a number of items. Experience in recent years provides numerous examples of the range of conflicts. These include: income and balance-sheet disclosure (and, more recently, market valuation) versus the exposure of the deposit insurance fund to disclosure of adverse change; CRA performance versus permission to branch; capital sufficiency versus permission for a bank to expand by acquisition; and the forgone income tied to reserve requirements versus monetary control. While this process may not extend to a formal cost-benefit calculus, factors (and their weights) leading to a conclusion should be disclosed.

Conflict resolution has become more complex because of the increased responsibilities placed on regulators of financial institutions and also the widening range of activities being undertaken by the institutions themselves. Regulation of financial services is not confined to banks; nor is regulatory oversight confined to bank regulatory agencies. With the possible exception of prompt corrective action under FDICIA, Congress rarely specifies priorities among objectives it sets for regulatory agencies. Consequently, regulators generally are left to do so themselves. They may proceed on the basis of inferred congressional priorities at the time the legislation was enacted, current congressional preferences, or their own objectives. One of the latter may be empire building, especially among permanent staff members of a regulatory agency. While information

processing and response by an agency are not independent of the external operating environment, they tend to reflect preferences emanating from an organization's past behavioral patterns and traditions—its "culture."

Trade-off accountability

Delineating regulatory objectives is quite distinct from regulatory "ownership" of a given financial function. Better articulation of regulatory objectives should be accompanied by clear-cut accountability for results. Organizationally, this may entail a separate bureau within a given agency or separate agencies. There are numerous ways in which these principles might find organizational expression. Some are:

- Separate chartering and powers responsibilities from supervision and capital oversight functions;
- place "truth in. . ." responsibility covering all suppliers of financial services in a separate bureau, such as the Federal Trade Commission;
- separate all public reporting, disclosure, and accounting oversight in a single bureau;
- separate attention to conflicts and abuses in a single policing entity, such as the Securities and Exchange Commission;
- separate oversight for allocative preferences in the agency responsible for the services being fostered, such as the Department of Housing and Urban Development.

Steps along these lines probably would generate new contesting between agencies or bureaus—a condition to be encouraged, not to be avoided. Uncertain public preference standards (as reflected in conflict) would create impetus for resolving action by the Congress, not by an agency. Shortcomings in regulatory performance would be more visible, since the internal trade-off process would no longer afford protection to regulators.

In summary, changes in the organization of financial regulation should reinforce explicitly the need for more public disclosure of the ways in which conflicting regulatory objectives are reconciled. Inadequate disclosure impairs accountability. Internalizing conflict resolution also may lead to wasteful avoidance tactics on the part of the regulated and undisclosed (and congressionally unintended) priority systems on the part of regulators. Accordingly, new proposals for change in regulatory agencies should be subjected to the test of how conflict resolution will be improved.

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COMMENTARY

Fed

Federal Banking Agency Reform: The Central Bank Connection

By Carter H. Golembe

Consolidation of the federal banking agencies has surfaced once again as a full-bodied legislative issue. The administration's proposal for a new banking agency will see to that. I have lost count of the number of times this and similar proposals have emerged during the past half-century or so, but I am willing to bet that the first appeared within weeks of the creation of the present structure on January 1, 1934.

The reason is that the structure seems almost unworkable, thus offering an irresistible temptation to every new administration—indeed, to every private and governmental committee or "task force" bent on reform—to seek to change it. Just as aerodynamic scientists tell us that the bumblebee cannot fly, so the political scientists tell us that the federal bank regulatory structure cannot work—but both do. Indeed, the federal banking agencies—as distinct from the federal thrift agencies—have turned in a more-than-creditable performance over the past 60 years.

> ***The Federal Reserve is seen as interested only in protecting its turf and, in particular, a very large number of employees.***

Not only do we have in prospect another full-fledged debate over reorganization of the federal bank regulatory structure, but we also face having to argue once again specific issues that have appeared time after time. Here I deal with just one of these, albeit one that is perhaps the most important in determining whether there will be any reform at all of the federal banking agency structure. It is the traditional contention by the Federal Reserve Board that a reform proposal that would consolidate all bank regulatory authority in a different or new federal agency or, short of consolidation, that would significantly reduce the Board's present bank regulatory authority is fatally flawed.

The administration's proposal is guilty on both counts—stripping the present banking agencies of their authority and placing it in a new agency rather than in the Federal Reserve. To no one's surprise, the Board of Governors immediately went on the attack: "It's the long-held conviction of the Board that a hands-on role in banking supervision is essential to carrying out the Federal Reserve's responsibility for the stability of the financial system, and is vital for the effective conduct of monetary policy." The article in the November 24 *Wall Street Journal* carrying this statement went on to comment, quite correctly, that "the central bank has helped derail similar regulatory consolidation proposals in the past."

Supporting the Fed

Several days later Fed Vice Chairman David Mullins continued the attack in an interview reported in the December 3 *Wall Street Journal.* Mullins charged that the administration's proposal would limit the central bank's ability to manage a crisis such as the 1987 stock market crash. On December 6, Rep. Jim Leach (R-Iowa), the ranking minority member of the House Banking Committee, weighed in against the administration plan in a speech before the Institute of International Bankers. Although not a fan of consolidation in any event, Leach said he would prefer seeing the present agencies merged into the Federal Reserve Board than into the superagency proposed by the administration. "The Fed has unique regulatory and supervisory expertise spread across the whole spectrum of the banking industry," he said, in addition to longstanding independence from political influence.

I have the strong impression that the idea that bank regulation is a necessary adjunct of monetary policy is advanced almost entirely by officials of the Federal Reserve. Most of those who do not accept that argument tend to regard it with "inside-the-beltway" cynicism. The Federal Reserve is seen as interested only in protecting its turf and, in particular, a very large number of employees—almost certainly a much larger number than those

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engaged in formulating and implementing monetary policy.

I do not share this view, although I am willing to concede that it may help explain the almost reflexive antagonism by the Board of Governors to any loss of its bank regulatory authority. However, I am convinced that there are many in the Federal Reserve System who believe quite sincerely that the conduct of monetary policy is accomplished more easily, and that the result is likely to be far better, so long as the System also has bank regulatory authority. The problem is that the reasons for this belief have never been presented for objective examination.

Fed's Responsibility

The responsibility for providing such evidence—the burden of proof, as it were—rests with the Federal Reserve Board. The intermixture of bank regulation and monetary policy is so clearly a conflict of interest that the burden could rest nowhere else. To be sure, the economic world presents many conflicts of interest and it is often the case that the benefits obtained require that the conflict be recognized, accepted, and dealt with in the best possible fashion. This is the kind of thing that might have to be done in this instance, but if so it should be done on the basis of evidence and careful thought rather than assertion.

> *In some nations the successful conduct of monetary policy is assured by keeping the central banks out of the bank regulatory business.*

Bank supervision and regulation is directed essentially at assuring a safe and a sound banking system; monetary policy is concerned primarily with providing a monetary framework within which there can be economic growth without inflation. Ironically, the essence of the conflict has never been more effectively described than by a former member of the Federal Reserve Board—and at the time probably the nation's outstanding authority on bank regulation—Board Vice Chairman J. L. Robertson, who in 1962 urged that bank regulatory authority should be taken from the Federal Reserve and put in an independent agency because "in appraising the soundness of loans or investments, bank examiners should never be obliged to switch from rose-colored glasses to black ones, and back and forth again, in an effort to implement the monetary policy of the moment." (Annual Convention of the Tennessee Bankers Association, May 16, 1962, reprinted in "Hearings on the Federal Bank Commission Act of 1977," Senate, p. 500)

For those of us who question the intermixture of bank regulation and monetary policy, an interesting and supporting piece of evidence appeared in the November 20 edition of the *Economist*. There, in the course of a discussion of whether the Bank of England should be made independent along the lines of the Federal Reserve, the *Economist* called attention to an essay by a Harvard economist, Adam Posen, which, among other things, argued that "countries whose central banks do not regulate financial institutions are often keener against inflation." Presumably paraphrasing Posen, the *Economist* noted that "Germany and Switzerland, which have historically had both the most independent central banks and the lowest inflation, have universal banking [and] divorce their central banks from bank supervision." It appears, in other words, that in some nations the successful conduct of monetary policy is assured by keeping the central banks out of the bank regulatory business.

Fed View Challenged

In making its case that bank regulatory authority "is vital for the effective conduct of monetary policy," the Board of Governors conceivably may argue that there is no conflict; that the objective of bank safety and soundness should be made subordinate to the conduct of monetary policy. As a matter of fact, an argument that the conduct and standards of bank supervision and regulation should be adjusted in order to help the Federal Reserve achieve its monetary policy goals has surfaced on occasion. For example, former Governor John E. Sheehan, in a speech made in 1974, argued that all bank supervisory and regulatory authority should be consolidated in the Board of Governors because "the monetary authorities must be able to readily effect changes in the regulatory policy and the supervisory apparatus and action which they believe to be necessary to carry out their responsibilities." (December 10, 1974, before the Institutional Investors Institute, in New York City.) In other words, what Governor Robertson had identified as an evil to be eliminated was, according to Governor Sheehan, something to be cherished!

It would be nice to believe that this statement by Governor Sheehan was an aberration—which was the way I treated it in an article at the time—but one always has the uneasy feeling that somewhere in the Federal Reserve the idea still lurks. And unless my good friend John D. Hawke, a former general counsel of the Federal Reserve Board and now partner in a prestigious Washington law firm of Arnold & Porter, was [illegible]

the press, his explanation (but not his support) for the Fed's opposition to the administration's current proposal lends some credence to these fears. According to the November 24 edition of the *American Banker*, Hawke said "the Fed does not want to cede its regulatory duties, because that's where it gets much of its sway over banks .... Its ability to jawbone banks stems from its regulatory leverage." And as an example, he said "without the power to approve bank applications . . . the Fed loses the ability to make banks do what it wants."

This is indeed a chilling prospect—the idea that monetary policy should be carried out in part by using regulatory authority to compel banks to take or not take certain actions believed to have a monetary effect desired by the Board of Governors. It is tempting to believe that this kind of thing could never happen, and yet it has happened, and when it does it exposes the inherent conflict of interest in its most extreme form.

The Prime Rate Episode

In 1973, for example, the conduct of monetary policy included reliance on personal contacts by Federal Reserve officials for such purposes as persuading banks to hold back prime rate changes dictated by the market forces set into motion by the Fed's own open market operations. Bankers are accustomed to the use of pressure by regulatory agencies to achieve safety and soundness objectives. But what is a banker to think when asked to take (or not take) action with respect to interest rates or lending in order to support a monetary policy or economic stability objective, when the agency making the request is also the banking regulator—a regulator that at the same time is acting on applications for acquisitions or other bank initiatives. Some readers may recall that this was the situation when the chairman of the Federal Reserve was also chairman of President Nixon's Committee on Interest and Dividends. It was not a happy state of affairs. Bottom line: if a principal purpose for allowing the Federal Reserve to have some bank regulatory authority is to permit that agency to carry out monetary policy by making "banks do what it wants," even at times at the cost of bank safety and soundness, then Congress and everyone else ought to be made aware of this.

Professional Relationships

Occasionally, Federal Reserve officials have suggested that involvement in bank regulation enables the Federal Reserve to maintain continuing professional relationships throughout the banking industry—relationships that can be useful in helping the Board retain its independence. Central bank independence when it comes to the conduct of monetary policy is so important, in my opinion, that this might possibly be thought of as justification for permitting this conflict of interest to continue. However, membership requirements rather than regulatory powers are what really enable the Federal Reserve to build a strong—and I think justified—public relations base of advisory committees, conferences, and the like—to be called upon when politicians threaten independence. Bank examination and other supervisory powers do not have, and probably should not have, anything to do with this.

> ***This is indeed a chilling prospect—the idea that monetary policy should be carried out in part by using regulatory authority to compel banks to take or not take certain actions.***

My assumption has always been that the argument by Federal Reserve officials of the need to have both kinds of authority must be based largely, if not entirely, on the idea that involvement in bank supervision and regulation gives to the Board or, more particularly, the Federal Open Market Committee (consisting of the Board and five Federal Reserve Bank Presidents) a "window on banking"—the kind of "hands-on" knowledge of what is happening that could not be obtained elsewhere. Possibly regulatory officials at the central bank are more sensitive to monetary policy matters, and thus are able to provide a more useful flow of information to the Federal Open Market Committee than could the reports of other regulatory officials in other agencies. Perhaps this is particularly the case when it comes to international banking developments. All of this, together with just the sheer volume of information obtained directly through supervisory and regulatory activities, helps make the Federal Open Market Committee a far more effective body.

Possibly so, and possibly there is persuasive evidence of this. Frankly, I think there may be, but it has not been made available, at least insofar as I am aware. Until this happens, I will continue to regard with some skepticism the proposition that a bank antitrust analysis by a Federal Reserve lawyer is somehow tinged with monetary policy values not to be found in an analysis done by an FDIC lawyer. I also will continue to doubt the proposition that a bank examination report signed by an examiner employed by the Federal Reserve Board makes a greater contribution to the knowledge of the members of the Federal Open Market Committee than one signed by an employee of the Comptroller of the Currency.

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Statement No. 103

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Statement of the Shadow Financial Regulatory Committee

on

PRINCIPLES OF REGULATORY RESTRUCTURING

February 14, 1994

A number of proposals have been made to reorganize the powers and responsibilities of federal agencies that regulate and supervise depository institutions. As an aid to evaluating these proposals, the Committee recommends that the following policy goals and institutional principles guide any agency restructuring.

I. General Objectives of the Regulatory and Supervisory Structure

Restructuring proposals should be judged in terms of the following five objectives:

1. to increase the operational efficiency of financial institutions and regulatory bodies;

2. to improve the efficiency of financial markets in the allocation of resources;

3. to assure ample opportunity for innovation in financial markets;

4. to better control deposit insurance loss exposure; and

5. to make monetary policy more effective.

II. Implied Principles of Supervisory and Regulatory Structure

1. Effective regulatory, supervisory, and monetary-policy performance requires that responsible authorities be held accountable for the decisions they make. Accountability is fostered by:

    a. clarity in goals and policies;

    b. transparency of policy decisions and the underlying decision criteria;

    c. consistent application of policies, across institutions and over time;

    d. insulation of policies from short-term political considerations; and

    e. the assignment of potentially conflicting goals to separate agencies. Responsibility for monetary policy and prudential regulation should not be lodged in the same supervisory agency. Responsibility for approving new institutions and products should be separated from the insuror or guarantor responsibility.

2. Operational efficiency of supervisory authorities is enhanced by simplification of the regulatory and supervisory structure.

PREPARED STATEMENT OF EDWARD J. KANE

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Efforts to reassign deposit-institution regulatory turf have covert as well as overt dimensions. Overtly, all parties merely want to serve taxpayers better. Covertly, parties pursue narrower goals that in varying degrees conflict with this estimable objective.

As usual, the front-line warriors in the struggle for financial regulatory consolidation are the Treasury and the Federal Reserve. Overtly, both parties seek a framework of prudential supervision that would have three properties. First, the system would be easy to understand and cost-efficient. Second, it would be compatible with effective strategies of monetary control. Third, it would be responsive over time to opportunities offered by evolving technologies of information and communication. But enough conflict exists among these overt goals that either agency can promote a hidden agenda merely by ranking these overarching objectives in a way that meets its unacknowledged purposes.

Current Battlelines

In late 1993, Treasury officials renewed the debate and redefined interagency battlelines by identifying potential benefits that institutions and taxpayers might reap from eliminating overlaps in Federal supervisory and regulatory authority. Without supporting evidence, three principal classes of benefit were asserted: increased accountability, due to a more straightforward bureaucratic structure; greater operational efficiency, made possible by bureaucratic consolidation; and more flexible and less conflicted responses to evolving technological opportunities. Emphasis was placed on eliminating longstanding bureaucratic conflicts of interest that have come from housing contradictory responsibilities in a single agency: (1) between the Fed's monetary responsibilities and its supervisory and regulatory dominion over bank holding companies and State-chartered member banks, and (2) between the FDIC's narrow concern for protecting deposit-insurance reserves and its broader regulatory and supervisory responsibilities.

By definition, covert Treasury objectives are a matter of speculation. But, in the past, the Treasury has shown interest in being able to influence more directly the allocation of credit. The structure it is proposing would facilitate this if that is in fact a covert objective.

Fed spokespersons have reacted as if they perceive the Treasury's overt objectives to be an ignoble and covert turf grab, aimed at reducing the political clout of the Fed and further curtailing the ability of State deposit-institution regulators to influence Federal banking policies as strongly as they did during the deposit-insurance mess. Articulating these suspicions has turned the debate into a high-profile shouting match. Top Fed officials have openly ridiculed the Treasury plan and countered with a still-evolving consolidation plan of their own.

The Fed's counterproposal incorporates three turf-protecting thrusts. First, Fed officials denigrate the accountability issue by asserting that regulatory authority is essential to effective monetary management. Second, they argue that equal operational efficiency and even greater technological adaptiveness could be obtained—as benefits of regulatory competition—by keeping two Federal banking regulators in play. Third, they use their responsibility for crisis management as a fulcrum for time-honored scare tactics that assert that the Fed must be made one of the surviving regulators. Fed spokespersons claim—without objective evidence or logical argument—that our central bank would have done an *even worse job* in dealing with the 1990–1993 economic slowdown and 1982, 1985, and 1987 liquidity crises had it not enjoyed "direct, hands-on involvement in supervision and regulation." The spectacle of Fed officials congratulating themselves for not having all together fallen on their face in recent years is amusing. But it is instructive that these officials have not chosen to compare their monetary-policy success with countries such as Switzerland that have operated under a split structure.

Analysis of Treasury and Federal Reserve Concerns

The Shadow Financial Regulatory Committee issued statements on regulatory consolidation in December 1993 and February 1994. I subscribe to these statements and offer them (along with short papers by Richard Aspinwall and Carter Golembe) as an appendix to my testimony.

The Shadow Committee's Statement No. 100 suggests an important, but straightforward modification in the composition of the Commission proposed by the Treasury. Substituting the FDIC Chairman for the Secretary of the Treasury would better balance the governing board and neutralize concerns about the Treasury's gaining

turf and credit-allocation leverage. More importantly, the statement urges that the *internal organizational structure* of the consolidated agency be designed to enhance accountability.

Part II of the Shadow Committee's Statement No. 103 cites five principles of organizational structure that foster accountability in monetary and regulatory policymaking:

a. clarity in goals and policies;
b. transparency of policy decisions and underlying decision criteria;
c. consistent application of policies across institutions and over time;
d. insulation of policies from *short-term* political considerations;
e. assignment of potentially conflicting goals to separate agencies.

In the past, Fed officials have often compromised on political insulation, while honoring the other four conditions only in the breach. My own past research and congressional testimony emphasize that the Fed's internal structure is directed toward *suppressing* rather than enhancing accountability. Experience tells us that the Fed is not prepared to revise its internal behavior to let outside observers see whether and how it minimizes the adverse effects of its monetary stabilization activity on the fabric of regulated institutions. Unless Congress adopts and applies principles like the ideals enunciated by the Shadow Committee, it cannot reasonably permit regulatory and supervisory responsibility over any banks or bank holding companies to remain with the Fed. This would make a mockery of the consolidation exercise.

To conduct monetary policy and run its discount window, what Federal Reserve officials need is not a conflict-prone supervisory relationship with banking organizations, but *rapid* access to *reliable* information on the changing condition of individual institutions and of the financial system as a whole. The current information system and supervisory structure fail to give Fed policymakers such access now and the Fed plan offers no improvements on this score.

A major advantage of pushing the Fed out of the supervisory and regulatory business would be to force Federal regulators to address the problems of collecting more meaningful information from banks and of making this information base *fully* accessible across agencies. Today, in-house examination staffs have virtually no contact with monetary policymakers. Moreover, unless critical information developed in "pencil drafts" of examination reports is being repressed by regional and national higher-ups, monetary policymakers have no need for direct access to field examiners or their particular supervisors.

Finally, I wish to express my astonishment that Federal Reserve Governors could expect the public to believe that the Treasury's proposed Federal Banking Commission (FBC) would be a "monolithic monopoly regulator" bound to operate in an inefficient and inflexible manner. Intense competition for the right to provide financial regulatory services has existed in financial markets for at least 25 years. Competitive pressure can be counted upon to remain intense enough to generate strong market discipline on Federal banking regulators, irrespective of whether Congress votes to consolidate their functions. Far from having a monopoly, the FBC would have to compete with private and governmental entities for regulating nonbank financial institutions and foreign activities of U.S. banks. As financial markets have globalized and nonbank institutions have developed more and better substitutes for traditional banking products, multilevel and cross-industry foreign, State, and Federal competition for the right to regulate financial services has become unrelenting. Continued advances in the technologies of information, communications, and financial contracting can be counted on to keep the FBC under disciplinary pressure from a host of substitute regulators. Indeed, as the S&L insurance mess shows, the strength of this pressure is what makes establishing better accountability for Federal supervisory and regulatory performance such a critical task.

In an environment of compromise and accommodation, all too often political solutions sacrifice principles of good Government. I urge your Committee to apply rigorously to any and all restructuring proposals the test of whether and how they advance the five principles enunciated earlier:

a. clarity in goals and policies;
b. transparency of policy decisions and underlying decision criteria;
c. consistent application of policies across institutions and over time;
d. insulation of policies from short-term political considerations;
e. assignment of potentially conflicting goals to separate agencies.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ROTH FROM LLOYD BENTSEN

Q.1. If the Federal Banking Commission is to regulate both national and State chartered banks under your proposal, is it not natural for it to favor the banks it created—its own children, so to speak—over those from other families, i.e., the States?

A.1. The Administration understands the concerns of those who fear that a national charter might be the preferred charter under our consolidation proposal. However, the Federal Banking Commission (FBC)—precisely because it would regulate all institutions, both State and Federal—would have no reason to discriminate against State-chartered institutions. We believe that a Federal regulator responsible for both State- and federally-chartered institutions and for both banks and thrifts would gain broader perspectives and would be less entrenched, and more open to diversity and innovation, than one with more limited scope. Any effort to disadvantage State-chartered institutions would be senseless because it would be challenged by Members of Congress and regulators from 50 States.

There is no evidence that a single Federal regulator would even try to discriminate against State institutions. The Office of Thrift Supervision regulates both State- and federally-chartered institutions without difficulty. The FBC can do the same.

Q.2. If the Federal Banking Commission is to regulate both national and State banks, will the non-conforming powers of State banks become over time to be viewed as "different" and, therefore, bad policy?

A.2. Nothing in the Administration's bill would authorize the FBC to override State law to limit State bank powers. The bill would retain current law, under which the Federal Deposit Insurance Corporation is the only Federal agency authorized to restrict State bank powers, and then only to protect the deposit insurance fund.

Q.3. It seems to me that the primary Federal reason to have a Federal regulator of State banks is safeguarding the deposit insurance fund. Since the FDIC is not extinguished under your proposal, why not allow the FDIC to be the Federal regulator of State banks, since State banks will, of course, be fully regulated at the State level?

A.3. Safeguarding the deposit insurance fund is not the only reason to have a Federal regulator for State banks. Federal supervision of both types of institutions is necessary to help preserve the stability of the financial system. State-chartered institutions comprise a significant proportion of the banking industry, and State- and federally-chartered institutions interact frequently and pervasively.

Moreover, the Administration's proposal seeks to separate the regulatory and deposit insurance functions, as we believe the two functions tend to conflict. When the insurance fund is solvent, the insurer has incentives to resist innovation because it wants to minimize risk. Unfortunately, innovations may be exactly what banks—and the financial system—need to meet evolving customer needs and ensure a healthy future. Thus, combining supervisory

and insurance responsibilities in the same agency may tend to stifle competition and growth.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MACK FROM LLOYD BENTSEN

Q.1. I am told that Under Secretary Newman has stated that regulatory consolidation could create as much as a $400 million industry savings, where will this savings go?

A.1. The industry savings would result from reduced compliance costs. A 1992 Federal Financial Institutions Examination Council (FFIEC) report cited studies estimating that banks' regulatory burden cost them from 6 percent to 14 percent of their non-interest expenses. In 1993, banks' non-interest expenses totalled $139.7 billion, so applying the 6 percent and 14 percent cost figures cited in the FFIEC report yields estimates of regulatory burden ranging from $8.4 billion to $19.6 billion. Even if regulatory consolidation reduced this burden by only 5 percent, the industry would save $420 million to $980 million per year.

These savings would make more resources available to depository institutions, which could then use the resources to lower costs for borrowers, expand lending activity and other services to customers, or raise dividends to shareholders. Although it is difficult to predict precisely how banks would deploy the savings, bank customers are likely to see benefits because of the competition within the financial services industry.

Q.2. What is your response to the concern that too much control over financial markets by one regulator could cause a credit crunch if lending to certain markets is deemed risky by that regulator?

A.2. First, it is by no means clear that a one-regulator system is more likely to cause a credit crunch than the current system. Our current regulatory structure did not prevent a credit crunch from developing in the late 1980's. Indeed, the four regulators' different perceptions of the problem and their different responses to it probably exacerbated the problem and postponed a solution.

Second, it is important to note that depository institutions no longer dominate the financial sector. Depository institutions hold only a third of financial industry assets and that share has been dropping for two generations.

Q.3. How is it possible to insulate a single regulatory agency from political influence, particularly when the Secretary of the Treasury sits on the Board?

A.3. The Administration's plan would, if anything, reduce the potential for politicizing bank regulation.

The Federal Banking Commission (FBC) would be governed by a five member board consisting of a Chairman appointed by the President and confirmed by the Senate; the Secretary of the Treasury or his designee; a member of the Federal Reserve Board; and two independent members appointed by the President and confirmed by the Senate. Board members would have staggered terms. Both major political parties would be represented on the Commission. The President could remove the FBC Chairman and other appointed members of the Commission only for specified cause.

I note, moreover, that under the current system, both the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS), which together supervise over 60 percent of all insured depository institution assets, are bureaus of the Treasury Department—whereas under the Administration's plan, Treasury would not have the exclusive supervisory authority over this portion of the banking system.

Q.4. Alan Greenspan (WSJ 1/18/94) has stated that removing the Federal Reserve from the direct, hands-on involvement in supervision and regulation will adversely effect its ability to anticipate and cope with potential systemic financial problems, that it is unrealistic to think that the Fed can do its job properly by studying the exam reports of another agency or by having representation on the board of a monolithic regulatory structure, what has the Administration done to meet these concerns?

A.4. The Administration's plan would not impair the Federal Reserve's ability to monitor systemic risk. The Federal Reserve, in addition to having a seat on the FBC's board, would have the opportunity to participate meaningfully in FBC examinations of both large and small banking organizations, and would have access to FBC information regarding 100 percent of bank and thrift assets. It is also important to note that today the Federal Reserve is able to adequately monitor systemic risk even though the institutions for which it has hands-on supervision hold only 15 percent of the total assets of FDIC-insured depository institutions.

The Administration's plan would not impair the Federal Reserve's ability to contain systemic risk. The Federal Reserve uses the discount window to manage systemic problems. The Administration's plan does not alter the Federal Reserve's discount window authority.

The Federal Reserve would remain integrally involved in banking. The Federal Reserve, as the Nation's central bank, would continue to conduct monetary policy, administer the payment system, and provide liquidity through the discount window. Under the Administration's plan, the Federal Reserve would retain full rulemaking and other authority necessary to carry out those responsibilities.

The Administration's proposal would not result in a monolithic supervisor. The structure of the FBC board and advisory committees would ensure that the FBC hears a diversity of views. The FBC would have advisory committees for community banks, thrifts, consumer issues, and small businesses.

Q.5. The Administration in its Summary on Consolidation has stated, "consolidation would eradicate the current opportunities for charter shopping and other competition in laxity," but doesn't the ability of a bank to change its charter serve as an important check against the promulgation of unreasonable regulation?

A.5. Congress, industry reaction, and the courts would serve as powerful and effective checks on any abuse of regulatory power by the FBC. In addition, the FBC itself would have an appeals process to ensure that complaints are appropriately considered. Aside from these checks, market forces (e.g., nonbank providers of financial services) ensure that the FBC would have little incentive to pro-

mulgate unreasonable regulations. State and foreign bank regulators also would have views that influence the FBC's positions.

Having a single regulator would not stifle industry criticism. The Securities and Exchange Commission, Food and Drug Administration, and Environmental Protection Agency—even though they are the sole Federal regulators in their respective fields—are no less subject than the Federal banking agencies to criticism from the industries they regulate. Bankers should have even less hesitation than in the past to come forward with complaints because the FBC would give institutions a process by which they can appeal agency decisions without fear of retribution.

Q.6. What has the Administration done to address the concern that consolidating regulatory agencies at the Federal level will threaten the dual banking by eliminating the availability of a State charter that carries with it the choice of a Federal regulator? A monolithic Federal supervisor which also issues Federal charters will have little incentive to accommodate diverse State standards or to maintain the value of State charters.

A.6. The FBC would not be monolithic by any stretch of the imagination. The Federal Deposit Insurance Corporation (FDIC) and Federal Reserve would both remain integrally involved in banking; the FDIC would continue to have back-up enforcement authority, and the Federal Reserve would continue to control monetary policy and payment system.

State banking regulators actually would have *more* responsibility under the Administration's plan than they now have. The FBC would have authority to certify State banking departments that have demonstrated their skill in conducting examinations. The FBC would rely on, and not duplicate, certified State agencies' examinations of well-capitalized State-chartered banks with less than $250 million in assets. Under this approach, it is likely that almost 60 percent of all State banks would be examined only by State regulators. States would remain the primary regulator of State banks. Under the Administration's plan, only the FDIC, not the FBC, would be able to limit State bank powers, and only then when the FDIC believes it is necessary to protect the insurance fund.

Q.7. It is my understanding that the OCC has instituted an appeals process for bankers who feel that examiners have been too hard on them, what is the status of this process, how is it functioning, and how will it operate under the Administration's regulatory consolidation plan?

A.7. The Administration recognizes the importance of providing a regulated industry with the opportunity to raise complaints with an ombudsman out of the regular chain of command. The OCC appeals process, now fully operational, does just that. The process is simple, quick, and requires little paperwork. Under the OCC appeals process, bankers can either complain in writing to the district head, or write directly to the OCC ombudsman. To date, the OCC ombudsman has completed work on 28 appeals, with the bank upheld in 16 cases and partially upheld in many of the remaining 12 cases.

The Administration supports a statutory framework for the appeals process, as evidenced by its inclusion in our consolidation

proposal and our support for similar language in the community development banking legislation.

Q.8. This consolidation plan is in part being put forward for the purpose of regulatory relief on our Nation's financial institutions. As you know, Senator Shelby and I have introduced legislation that would give the regulators the *DISCRETION* to examine well-capitalized community banks with a composite rating of good (CAMEL 2) on an 18-month exam cycle. Do you believe that the regulators are capable of handling this discretion, and would you support this amendment?

A.8. We have generally supported revising section 111 of FDICIA to increase regulators' discretion to examine healthy small institutions on an 18-month—rather than 12-month—cycle, and we believe regulators are capable of handling the increased discretion.

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